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Income Tax Regulations; Taxable Years Beginning After December 31, 1953

Title 26—INTERNAL REVENUE, 1954

Chapter I—Internal Revenue Service, Department of the Treasury

[T.D. 6500]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Republication of Regulations

All Income Tax Regulations published under Title 26, Part 1, of the Code of Federal Regulations, pursuant to the Internal Revenue Code of 1954 prior to September 1, 1960, are hereby republished for the purpose of making certain editorial changes, including corrections of form, style, and internal references.

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AUTHORITY: §§ 1.01 to 1.9100–1 issued under sec. 7805, 68A Stat. 917; 26 U.S.C. 7805. Statutory provisions interpreted or applied are cited to text.

§ 1.0–1 Internal Revenue Code of 1954 and regulations.

(a) *Enactment of law.* The Internal Revenue Code of 1954 which became law upon enactment of Public Law 591, 83d Congress, approved August 16, 1954, provides in part as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) *Citation.* (1) The provisions of this Act set forth under the heading "Internal Revenue Title" may be cited as the "Internal Revenue Code of 1954".

(2) The Internal Revenue Code enacted on February 10, 1939, as amended, may be cited as the "Internal Revenue Code of 1939".

(b) *Publication.* This Act shall be published as volume 68A of the United States Statutes at Large, with a comprehensive table of contents and an appendix; but without an index or marginal references. The date of enactment, bill number, public law number, and chapter number, shall be printed as a headnote.

(c) *Cross reference.* For saving provisions, effective date provisions, and other related provisions, see chapter 80 (sec. 7801 and following) of the Internal Revenue Code of 1954.

(d) *Enactment of Internal Revenue Title into law.* The Internal Revenue Title referred to in subsection (a) (1) is as follows:

* * * * *

In general, the provisions of the Internal Revenue Code of 1954 are applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. Certain provisions of that Code are deemed to be included in the Internal Revenue Code of 1939. See section 7851.

(b) *Scope of regulations.* The regulations in this part deal with (1) the income taxes imposed under subtitle A of the Internal Revenue Code of 1954, and (2) certain administrative provisions contained in subtitle F of such Code relating to such taxes. In general, the applicability of such regulations is commensurate with the applicability of the respective provisions of the Internal Revenue Code of 1954 except that with respect to the provisions of the Internal Revenue Code of 1954 which are deemed to be included in the Internal Revenue Code of 1939, the regulations relating to such provisions are applicable to certain fiscal years and short taxable years which are subject to the Internal Revenue Code of 1939. Those provisions of the regulations which are applicable to taxable years subject to the Internal Revenue Code of 1939 and the specific taxable years to which such provisions are so applicable are identified in each instance. The regulations in 26 CFR (1939) Part 39 (Regulations 118) are continued in effect until superseded by the regulations in this part. See Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167, C.B. 1954–2, 47).

Normal Taxes and Surtaxes

DETERMINATION OF TAX LIABILITY

TAX ON INDIVIDUALS

§ 1.1 Statutory provisions; tax imposed.

SECTION 1. *Tax imposed*—(a) *Rates of tax on individuals.* A tax is hereby imposed for each taxable year on the taxable income of every individual other than a head of a household to whom subsection (b) applies. The amount of the tax shall be determined in accordance with the following table:

If the taxable income is:	The tax is:
Not over $2,000	20% of the taxable income.
Over $2,000 but not over $4,000	$400, plus 22% of excess over $2,000.
Over $4,000 but not over $6,000	$840, plus 26% of excess over $4,000.
Over $6,000 but not over $8,000	$1,360, plus 30% of excess over $6,000.
Over $8,000 but not over $10,000	$1,960, plus 34% of excess over $8,000.
Over $10,000 but not over $12,000	$2,640, plus 38% of excess over $10,000.
Over $12,000 but not over $14,000	$3,400, plus 43% of excess over $12,000.
Over $14,000 but not over $16,000	$4,260, plus 47% of excess over $14,000.
Over $16,000 but not over $18,000	$5,200, plus 50% of excess over $16,000.
Over $18,000 but not over $20,000	$6,200, plus 53% of excess over $18,000.
Over $20,000 but not over $22,000	$7,260, plus 56% of excess over $20,000.
Over $22,000 but not over $26,000	$8,380, plus 59% of excess over $22,000.
Over $26,000 but not over $32,000	$10,740, plus 62% of excess over $26,000.
Over $32,000 but not over $38,000	$14,460, plus 65% of excess over $32,000.
Over $38,000 but not over $44,000	$18,360, plus 69% of excess over $38,000.
Over $44,000 but not over $50,000	$22,500, plus 72% of excess over $44,000.
Over $50,000 but not over $60,000	$26,820, plus 75% of excess over $50,000.
Over $60,000 but not over $70,000	$34,320, plus 78% of excess over $60,000.
Over $70,000 but not over $80,000	$42,120, plus 81% of excess over $70,000.
Over $80,000 but not over $90,000	$50,220, plus 84% of excess over $80,000.
Over $90,000 but not over $100,000	$58,620, plus 87% of excess over $90,000.
Over $100,000 but not over $150,000	$67,320, plus 89% of excess over $100,000.
Over $150,000 but not over $200,000	$111,320, plus 90% of excess over $150,000.
Over $200,000	$156,820, plus 91% of excess over $200,000.

(b) *Rates of tax on heads of households*—(1) *Rates of tax.* A tax is hereby imposed for each taxable year on the taxable income of every individual who is the head of a household. The amount of the tax shall be determined in accordance with the following table:

If the taxable income is:	The tax is:
Not over $2,000	20% of the taxable income.
Over $2,000 but not over $4,000	$400, plus 21% of excess over $2,000.
Over $4,000 but not over $6,000	$820, plus 24% of excess over $4,000.
Over $6,000 but not over $8,000	$1,300, plus 26% of excess over $6,000.
Over $8,000 but not over $10,000	$1,820, plus 30% of excess over $8,000.
Over $10,000 but not over $12,000	$2,420, plus 32% of excess over $10,000.
Over $12,000 but not over $14,000	$3,060, plus 36% of excess over $12,000.
Over $14,000 but not over $16,000	$3,780, plus 39% of excess over $14,000.
Over $16,000 but not over $18,000	$4,560, plus 42% of excess over $16,000.
Over $18,000 but not over $20,000	$5,400, plus 43% of excess over $18,000.
Over $20,000 but not over $22,000	$6,260, plus 47% of excess over $20,000.
Over $22,000 but not over $24,000	$7,200, plus 49% of excess over $22,000.
Over $24,000 but not over $28,000	$8,180, plus 52% of excess over $24,000.
Over $28,000 but not over $32,000	$10,260, plus 54% of excess over $28,000.
Over $32,000 but not over $38,000	$12,420, plus 58% of excess over $32,000.
Over $38,000 but not over $44,000	$15,900, plus 62% of excess over $38,000.
Over $44,000 but not over $50,000	$19,620, plus 66% of excess over $44,000.
Over $50,000 but not over $60,000	$23,580, plus 68% of excess over $50,000.
Over $60,000 but not over $70,000	$30,380, plus 71% of excess over $60,000.
Over $70,000 but not over $80,000	$37,480, plus 74% of excess over $70,000.
Over $80,000 but not over $90,000	$44,880, plus 76% of excess over $80,000.
Over $90,000 but not over $100,000	$52,480, plus 80% of excess over $90,000.
Over $100,000 but not over $150,000	$60,480, plus 83% of excess over $100,000.
Over $150,000 but not over $200,000	$101,980, plus 87% of excess over $150,000.
Over $200,000 but not over $300,000	$145,480, plus 90% of excess over $200,000.
Over $300,000	$235,480, plus 91% of excess over $300,000.

(2) *Definition of head of household.* For purposes of this subtitle, an individual shall be considered a head of a household if, and only if, such individual is not married at the close of his taxable year, is not a surviving spouse (as defined in section 2 (b)), and either—

(A) Maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of—

(i) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer, but if such son, stepson, daughter, stepdaughter, or descendant is married at the close of the taxpayer's taxable year, only if the taxpayer is entitled to a deduction for the taxable year for such person under section 151, or

(ii) Any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under section 151, or

(B) Maintains a household which constitutes for such taxable year the principal place of abode of the father or mother of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151.

For purposes of this paragraph and of section 2 (b) (1) (B), an individual shall be considered as maintaining a household only if over half of the cost of maintaining the household during the taxable year is furnished by such individual.

(3) *Determination of status.* For purposes of this subsection—

(A) A legally adopted child of a person shall be considered a child of such person by blood;

(B) An individual who is legally separated from his spouse under a decree of

divorce or of separate maintenance shall not be considered as married;

(C) A taxpayer shall be considered as not married at the close of his taxable year if at any time during the taxable year his spouse is a nonresident alien; and

(D) A taxpayer shall be considered as married at the close of his taxable year if his spouse (other than a spouse described in subparagraph (C)) died during the taxable year.

(4) *Limitations.* Notwithstanding paragraph (2), for purposes of this subtitle a taxpayer shall not be considered to be a head of a household—

(A) If at any time during the taxable year he is a nonresident alien; or

(B) By reason of an individual who would not be a dependent for the taxable year but for—

(i) Paragraph (9) of section 152 (a),

(ii) Paragraph (10) of section 152 (a), or

(iii) Subsection (c) of section 152.

(c) *Special rules.* The tax imposed by subsection (a), and the tax imposed by paragraph (1) of subsection (b), consists of—

(1) A normal tax of 3 percent of the taxable income, and

(2) A surtax equal to (A) the amount determined in accordance with the table in subsection (a) or paragraph (1) of subsection (b), minus (B) the normal tax. The tax shall in no event exceed 87 percent of the taxable income for the taxable year.

(d) *Cross reference.* For definition of taxable income, see section 63.

§ 1.1–1 Income tax on individuals.

(a) *General rule.* (1) Section 1(a) of the Code imposes an income tax on every individual, resident or nonresident, other than a head of a household to whom section 1(b) applies or a nonresident alien individual subject to the tax imposed by section 871(a). This tax consists of a normal tax and a surtax. See section 1(c). For optional tax in the case of taxpayers with adjusted gross incomes of less than $5,000, see section 3. The tax imposed by section 1(a) is upon taxable income (determined by subtracting the allowable deductions from the gross income). The tax is determined in accordance with the table contained in section 1(a). In certain cases credits are allowed against the amount of the tax. See part IV (section 31 and following, subchapter A, chapter 1 of the Code. In general, the tax is payable upon the basis of returns rendered by persons liable therefor (subchapter A (section 6001 and following), chapter 61 of the Code) or at the source of the income. For computation of tax in the case of a joint return of husband and wife, or a return of a surviving spouse, see section 2. For other rates of tax on individuals, see section 5(a). See part III (section 551 and following), subchapter G, chapter 1 of the Code, as to shareholders of foreign personal holding companies. See subchapter P (section 1201 and following), chapter 1 of the Code, as to the treatment of capital gains and losses.

(2) The income tax imposed by section 1 (a) upon any amount of taxable income is computed by adding to the income tax for the bracket in which that amount falls in the table in section 1 (a) the income tax upon the excess of that amount over the bottom of the bracket at the rate indicated in the table. Accordingly, the income tax for a taxable year beginning after December 31, 1953, upon a taxable income of $16,480 would be $5,440, computed as follows:

Tax on $16,000 (from table)	$5,200
Tax on $480 (at 50 percent as determined by the table)	240
Total tax on $16,480	5,440

(b) *Citizens or residents of the United States liable to tax.* In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States. A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in general, subject to taxation in the same manner as a resident alien individual. See section 876, relating to alien residents of Puerto Rico. As to tax on nonresident alien individuals, see section 871.

(c) *Who is a citizen.* Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. For rules governing loss of citizenship, see sections 349 to 357, inclusive, of the Immigration and Nationality Act (8 U.S.C. 1481–1489). A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is an alien.

§ 1.1–2 Rates of tax on heads of households.

(a) *General rule.* An individual who is the head of a household under the rules prescribed in section 1(b) is subject to the income tax imposed by that section instead of the income tax imposed by section 1(a).

(b) *Definition of head of household.* (1) For the purpose of section 1 (b), the taxpayer shall be considered the head of a household if, and only if, he is not married at the close of his taxable year, is not a surviving spouse (as defined in section 2 (b)), and (i) maintains as his home a household which constitutes for such taxable year the principal place of abode, as a member of such household, of at least one of the individuals described in section 1 (b) (2) (A), or (ii) maintains (whether or not as his home) a household which constitutes for such taxable year the principal place of abode of one of the individuals described in section 1 (b) (2) (B).

(2) Under no circumstances shall the same person be used to qualify more than one taxpayer as the head of a household for the same taxable year.

(3) Subparagraph (A) of section 1 (b) (2) provides that any of the following persons may qualify the taxpayer as a head of a household:

(i) A son, stepson, daughter, or stepdaughter of the taxpayer, or a descendant of a son or daughter of the taxpayer. For the purpose of determining whether any of the stated relationships exist, a legally adopted child of a person is considered a child of such person by blood. If any such person is not married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person even though the taxpayer may not claim a deduction for such person under section 151, for example, because the taxpayer does not furnish more than half of the support of such person. However, if any such person is married at the close of the taxable year of the taxpayer, the taxpayer may qualify as the head of a household by reason of such person only if the taxpayer is entitled to a deduction for such person under section 151 and the regulations thereunder. In applying the preceding sentence there shall be disregarded any such person for whom a deduction is allowed under section 151 only by reason of section 152 (c) (relating to persons covered by a multiple support agreement).

(ii) Any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the taxable year for such person under section 151 and the regulations thereunder. Under section 151 the taxpayer may be entitled to a deduction for any of the following persons:

(*a*) His brother, sister, stepbrother, or stepsister;

(*b*) His father or mother, or an ancestor of either;

(*c*) His stepfather or stepmother;

(*d*) A son or a daughter of his brother or sister;

(*e*) A brother or sister of his father or mother; or

(*f*) His son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law;

if such person has a gross income of less than $600 for the calendar year in which the taxable year of the taxpayer begins, if the taxpayer supplies more than one-half of the support of such person for such calendar year and if such person does not make a joint return with his spouse for the taxable year beginning in such calendar year. The taxpayer may not be considered to be a head of a household by reason of any person for whom a deduction is allowed under section 151 only by reason of section 152 (a) (9), 152 (a) (10), or 152 (c) (relating to persons not related to the taxpayer, persons receiving institutional care, and persons covered by multiple support agreements).

(4) Subparagraph (B) of section 1 (b) (2) provides that the father or mother of the taxpayer may qualify the taxpayer as a head of a household, but only if the taxpayer is entitled to a deduction for the taxable year for such father or mother under section 151 (determined without regard to section 152 (c)). For example, an unmarried taxpayer who maintains a home for his widowed mother may not qualify as the head of a household by reason of his maintenance of a home for his mother if his mother has gross income of $600 or more in the calendar year in which his taxable year begins, or if he does not furnish more than one-half of the support of his mother for such calendar year. For purposes of subparagraph (B) of section 1 (b) (2), a person who legally adopted the taxpayer is considered the father or mother of the taxpayer.

(5) For the purpose of section 1 (b), the status of the taxpayer shall be deter-

mined as of the close of the taxpayer's taxable year. A taxpayer shall be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of divorce or separate maintenance, or if at any time during the taxable year the spouse to whom the taxpayer is married at the close of his taxable year was a nonresident alien. A taxpayer shall be considered married at the close of his taxable year if his spouse (other than a spouse who is a nonresident alien) dies during such year.

(6) If the taxpayer is a nonresident alien during any part of the taxable year he may not qualify as a head of a household even though he may comply with the other provisions of section 1 (b). See the regulations prescribed under section 871 for a definition of nonresident alien.

(c) *Household.* (1) In order for the taxpayer to be considered a head of a household by reason of any individual described in subparagraph (A) of section 1 (b) (2), the household must actually constitute the home of the taxpayer for his taxable year. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. Such home must also constitute the principal place of abode of at least one of the persons specified in such subparagraph (A). It is not sufficient that the taxpayer maintain the household without being its occupant. The taxpayer and such other person must occupy the household for the entire taxable year of the taxpayer. However, the fact that such other person is born or dies within the taxable year will not prevent the taxpayer from qualifying as a head of household if the household constitutes the principal place of abode of such other person for the remaining or preceding part of such taxable year. The taxpayer and such other person will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that the taxpayer or such other person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return.

(2) In order for the taxpayer to be considered a head of a household by reason of any individual described in subparagraph (B) of section 1 (b) (2), the household must actually constitute the principal place of abode of the taxpayer's dependent father or mother, or both of them. It is not, however, necessary for the purposes of such subparagraph for the taxpayer also to reside in such place of abode. A physical change in the location of such home will not prevent a taxpayer from qualifying as a head of a household. The father or mother of the taxpayer, however, must occupy the household for the entire taxable year of the taxpayer. They will be considered as occupying the household for such entire year notwithstanding temporary absences from the household due to special circumstances. For example, a nonpermanent failure to occupy the household by reason of illness or vacation shall be considered temporary absence due to special circumstances. Such absence will not prevent the taxpayer from qualifying as the head of a household if (i) it is reasonable to assume that such person will return to the household, and (ii) the taxpayer continues to maintain such household or a substantially equivalent household in anticipation of such return. However, the fact that the father or mother of the taxpayer dies within the year will not prevent the taxpayer from qualifying as a head of a household if the household constitutes the principal place of abode of the father or mother for the preceding part of such taxable year.

(d) *Cost of maintaining a household.* The taxpayer shall be considered as maintaining a household only if he pays more than one-half the cost thereof for his taxable year. The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants for such taxable year. The cost of maintaining a household shall not include expenses otherwise incurred. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation. In addition, the cost of maintaining a household shall not include any amount which represents the value of services rendered in the household by the taxpayer or by a person qualifying the taxpayer as a head of a household.

§ 1.1–3 Limitation on tax.

The tax imposed by section 1 (whether by subsection (a) or by subsection (b) thereof) shall not exceed 87 percent of the taxable income for the taxable year. For purposes of determining this limitation the tax under section 1 (a) or (b) and the tax at the 87 percent rate shall each be computed before the allowance of any credits against the tax. Where the alternative tax on capital gains is imposed under section 1201(b), the 87 percent limitation shall apply only to the partial tax computed on the taxable income reduced by 50 percent of the excess of net long-term capital gain over net short-term capital loss.

§ 1.1–4 Determination of normal tax and surtax.

The tax imposed by section 1 (whether by subsection (a) or by subsection (b) thereof) consists of a normal tax and a surtax. The normal tax equals 3 percent of the taxable income of the taxpayer and the surtax equals the remaining part of the combined tax computed in accordance with the tables in subsection (a) and subsection (b) of section 1 and with the limitation on tax in subsection (c) of section 1.

§ 1.1–5 Change in rates applicable to taxable year.

For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

§ 1.2 Statutory provisions; tax in case of joint return or return of surviving spouse.

SEC. 2. *Tax in case of joint return or return of surviving spouse*—(a) *Rate of tax.* In the case of a joint return of a husband and wife under section 6013, the tax imposed by section 1 shall be twice the tax which would be imposed if the taxable income were cut in half. For purposes of this subsection and section 3, a return of a surviving spouse (as defined in subsection (b)) shall be treated as a joint return of a husband and wife under section 6013.

(b) *Definition of surviving spouse*—(1) *In general.* For purposes of subsection (a), the term "surviving spouse" means a taxpayer—

(A) Whose spouse died during either of his two taxable years immediately preceding the taxable year, and

(B) Who maintains as his home a household which constitutes for the taxable year the principal place of abode (as a member of such household) of a dependent (i) who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer, and (ii) with respect to whom the taxpayer is entitled to a deduction for the taxable year under section 151.

(2) *Limitations.* Notwithstanding paragraph (1), for purposes of subsection (a) a taxpayer shall not be considered to be a surviving spouse—

(A) If the taxpayer has remarried at any time before the close of the taxable year, or

(B) Unless, for the taxpayer's taxable year during which his spouse died, a joint return could have been made under the provisions of section 6013 (without regard to subsection (a) (3) thereof) or under the corresponding provisions of the Internal Revenue Code of 1939.

§ 1.2–1 Tax in case of joint return of husband and wife or the return of a surviving spouse.

(a) In the case of a joint return of husband and wife, or the return of a surviving spouse as defined in section 2(b), the tax imposed by section 1 shall be twice the tax that would be imposed if the taxable income were reduced by one-half. For rules relating to the filing of joint returns of husband and wife and for method of computing gross income and adjusted gross income on such joint returns, see section 6013 and the regulations thereunder.

(b) The method of computing, under section 2 (a), the tax of husband and wife in the case of a joint return, or the tax of a surviving spouse, is as follows:

(1) First, the taxable income is reduced by one-half. Second, the tax is determined as provided by section 1 by using the taxable income so reduced. Third, the tax so determined, which is the tax that would be determined if the taxable income were reduced by one-half, is then multiplied by two to produce the tax imposed in the case of the

joint return or the return of a surviving spouse, subject, however, to the allowance of any credits against the tax under the provisions of sections 31 through 38 and the regulations thereunder.

(2) The limitation under section 1 (c) of the tax to an amount not in excess of a specified percent of the taxable income for the taxable year is to be applied before the third step above, that is, the limitation to be applied upon the tax is determined as the applicable specified percent of one-half of the taxable income for the taxable year (such one-half of the taxable income being the actual aggregate taxable income of the spouses, or the total taxable income of the surviving spouse, as the case may be, reduced by one-half). For the percent applicable in determining the limitation of the tax under section 1 (c), see § 1.1–3. After such limitation is applied, then the tax so limited is multiplied by two as provided in section 2 (a) (the third step above).

(3) The following computation illustrates the method of application of section 2 (a) in the determination of the tax of a husband and wife filing a joint return for the calendar year 1954. If the combined gross income is $8,200, and the only deductions are the two exemptions of the taxpayers under section 151 (b) and the standard deduction under section 141, the tax on the joint return for 1954, without regard to any credits against the tax, is $1,279.60, determined as follows:

1. Gross income			$8,200.00
2. Less:			
Standard deduction under section 141	$820		
Deduction for personal exemptions	1,200	2,020.00	
3. Taxable income			6,180.00
4. Taxable income reduced by one-half			3,090.00
5. Tax, computed by the tax table provided under section 1 (a) ($400 plus 22 percent of excess of $3,090 over $2,000)			$639.80
6. Twice the tax in item 5			1,279.60

(c) If the alternative tax is computed under section 1201 (b), relating to the alternative tax where a taxpayer (other than a corporation) has a net long-term capital gain in excess of a net short-term capital loss, the partial tax shall be computed as provided in paragraph (b) of this section but without inclusion of 50 percent of such excess in taxable income, and the total tax shall be such partial tax plus a specified percent of such excess as provided in such section 1201 (b).

(d) If a joint return of a husband and wife is filed under the provisions of section 6013 and if the husband and wife have different taxable years solely because of the death of either spouse, the taxable year of the deceased spouse covered by the joint return shall, for the purpose of the computation of the tax under section 2 (a) in respect of such joint return, be deemed to have ended on the date of the closing of the surviving spouse's taxable year.

(e) For computation of optional tax in the case of a joint return or the return of a surviving spouse, see section 3 and the regulations thereunder.

(f) For treatment of taxable years during which a change in the tax rates occurs see section 21 and the regulations thereunder.

§ 1.2–2 Definition of surviving spouse.

(a) If a taxpayer is eligible to file a joint return (either under the Internal Revenue Code of 1939 without regard to section 51(b)(4) thereof or under the Internal Revenue Code of 1954 without regard to section 6013(a)(3) thereof) for the taxable year in which his spouse dies, his return for each of the next two taxable years following the year of the death of the spouse shall be treated as a joint return for purposes of sections 2 (a) and 3 if all three of the following requirements are satisfied:

(1) He has not remarried before the close of the taxable year the return for which is sought to be treated as a joint return, and

(2) He maintains as his home a household which constitutes for the taxable year the principal place of abode as a member of such household of a person who is (whether by blood or adoption) a son, stepson, daughter, or stepdaughter of the taxpayer, and

(3) He is entitled for the taxable year to a deduction under section 151 (relating to deductions for dependents) with respect to such son, stepson, daughter, or stepdaughter.

A return of a surviving spouse may not be treated as a joint return unless it is for a taxable year beginning after December 31, 1953, and ending after August 16, 1954.

(b) Paragraphs (c)(1) and (d) of § 1.1–2 (relating to the head of a household) provides rules for the determination under section 1(b)(2)(A) of when the taxpayer maintains as his home a household which constitutes for the taxable year the principal place of abode, as a member of such household, of another person. These same rules shall also apply in the determination of whether the corresponding requirements under section 2 (b) (1) (B) have been satisfied.

(c) If the taxpayer does not qualify under section 2 as a surviving spouse he may nevertheless qualify under section 1 (b) as a head of a household if he meets the requirements of that section.

(d) The following example illustrates the provisions relating to a surviving spouse:

Example. Assume that the taxpayer meets the requirements of subparagraph (B) of section 2 (b) (1) for the years 1954 through 1958, and that the taxpayer, whose wife died during 1953 while married to him, remarried in 1955. In 1956, the taxpayer's second wife died while married to him, and he remained single thereafter. For 1954 the taxpayer will qualify as a surviving spouse, provided that neither the taxpayer nor the first wife was a nonresident alien at any time during 1953 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. For 1955 the taxpayer does not qualify as a surviving spouse because he remarried before the close of that taxable year. The taxpayer will qualify as a surviving spouse for 1957 and 1958, provided that neither the taxpayer nor the second wife was a nonresident alien at any time during 1956 and that she (immediately prior to her death) did not have a taxable year different from that of the taxpayer. On the other hand, if the taxpayer, in 1956, was divorced or legally separated from his second wife, the taxpayer will not qualify as a surviving spouse for 1957 or 1958, since he could not have filed a joint return for 1956 (the year in which his second wife died).

§ 1.3 Statutory provisions; optional tax if adjusted gross income is less than $5,000.

SEC. 3. *Optional tax if adjusted gross income is less than $5,000.* In lieu of the tax imposed by section 1, there is hereby imposed for each taxable year, on the taxable income of each individual whose adjusted gross income for such year is less than $5,000 and who has elected for such year to pay the tax imposed by this section, the tax shown in the following table:

If adjusted gross income is—		And the number of exemptions is—				If adjusted gross income is—		And the number of exemptions is—													
								1		2			3			4	5	6	7	8 or more	
At least	But less than	1	2	3	4 or more	At least	But less than	And taxpayer is single or married filing separately	And taxpayer is head of household	And taxpayer is single or married filing separately	And taxpayer is head of household	And a joint return is filed	And taxpayer is single or married filing separately	And taxpayer is head of household	And a joint return is filed						
		The tax is—						The tax is—													
$0	$675	$0	$0	$0	$0	$2,325	$2,350	$301	$301	$181	$181	$181	$61	$61	$61	$0	$0	$0	$0	$0	
675	700	4	0	0	0	2,350	2,375	305	305	185	185	185	65	65	65	0	0	0	0	0	
700	725	8	0	0	0	2,375	2,400	310	310	190	190	190	70	70	70	0	0	0	0	0	
725	750	13	0	0	0	2,400	2,425	314	314	194	194	194	74	74	74	0	0	0	0	0	
750	775	17	0	0	0	2,425	2,450	319	319	199	199	199	79	79	79	0	0	0	0	0	
775	800	22	0	0	0	2,450	2,475	323	323	203	203	203	83	83	83	0	0	0	0	0	
800	825	26	0	0	0	2,475	2,500	328	328	208	208	208	88	88	88	0	0	0	0	0	
825	850	31	0	0	0	2,500	2,525	332	332	212	212	212	92	92	92	0	0	0	0	0	
850	875	35	0	0	0	2,525	2,550	337	337	217	217	217	97	97	97	0	0	0	0	0	
875	900	40	0	0	0	2,550	2,575	341	341	221	221	221	101	101	101	0	0	0	0	0	
900	925	44	0	0	0	2,575	2,600	346	346	226	226	226	106	106	106	0	0	0	0	0	
925	950	49	0	0	0	2,600	2,625	350	350	230	230	230	110	110	110	0	0	0	0	0	
950	975	53	0	0	0	2,625	2,650	355	355	235	235	235	115	115	115	0	0	0	0	0	
975	1,000	58	0	0	0	2,650	2,675	359	359	239	239	239	119	119	119	0	0	0	0	0	
1,000	1,025	62	0	0	0	2,675	2,700	364	364	244	244	244	124	124	124	4	0	0	0	0	
1,025	1,050	67	0	0	0	2,700	2,725	368	368	248	248	248	128	128	128	8	0	0	0	0	
1,050	1,075	71	0	0	0	2,725	2,750	373	373	253	253	253	133	133	133	13	0	0	0	0	
1,075	1,100	76	0	0	0	2,750	2,775	377	377	257	257	257	137	137	137	17	0	0	0	0	
1,100	1,125	80	0	0	0	2,775	2,800	382	382	262	262	262	142	142	142	22	0	0	0	0	
1,125	1,150	85	0	0	0	2,800	2,825	386	386	266	266	266	146	146	146	26	0	0	0	0	
1,150	1,175	89	0	0	0	2,825	2,850	391	391	271	271	271	151	151	151	31	0	0	0	0	
1,175	1,200	94	0	0	0	2,850	2,875	395	395	275	275	275	155	155	155	35	0	0	0	0	
1,200	1,225	98	0	0	0	2,875	2,900	400	400	280	280	280	160	160	160	40	0	0	0	0	
1,225	1,250	103	0	0	0	2,900	2,925	405	404	284	284	284	164	164	164	44	0	0	0	0	
1,250	1,275	107	0	0	0	2,925	2,950	410	409	289	289	289	169	169	169	49	0	0	0	0	
1,275	1,300	112	0	0	0	2,950	2,975	415	414	293	293	293	173	173	173	53	0	0	0	0	
1,300	1,325	116	0	0	0	2,975	3,000	420	419	298	298	298	178	178	178	58	0	0	0	0	
1,325	1,350	121	1	0	0	3,000	3,050	427	426	305	305	305	185	185	185	65	0	0	0	0	
1,350	1,375	125	5	0	0	3,050	3,100	437	435	314	314	314	194	194	194	74	0	0	0	0	
1,375	1,400	130	10	0	0	3,100	3,150	447	445	323	323	323	203	203	203	83	0	0	0	0	
1,400	1,425	134	14	0	0	3,150	3,200	457	454	332	332	332	212	212	212	92	0	0	0	0	
1,425	1,450	139	19	0	0	3,200	3,250	467	464	341	341	341	221	221	221	101	0	0	0	0	
1,450	1,475	143	23	0	0	3,250	3,300	476	473	350	350	350	230	230	230	110	0	0	0	0	
1,475	1,500	148	28	0	0	3,300	3,350	486	482	359	359	359	239	239	239	119	0	0	0	0	
1,500	1,525	152	32	0	0	3,350	3,400	496	492	368	368	368	248	248	248	128	8	0	0	0	
1,525	1,550	157	37	0	0	3,400	3,450	506	501	377	377	377	257	257	257	137	17	0	0	0	
1,550	1,575	161	41	0	0	3,450	3,500	516	511	386	386	386	266	266	266	146	26	0	0	0	
1,575	1,600	166	46	0	0	3,500	3,550	526	520	395	395	395	275	275	275	155	35	0	0	0	
1,600	1,625	170	50	0	0	3,550	3,600	536	530	404	404	404	284	284	284	164	44	0	0	0	
1,625	1,650	175	55	0	0	3,600	3,650	546	539	414	413	413	293	293	293	173	53	0	0	0	
1,650	1,675	179	59	0	0	3,650	3,700	556	549	424	423	422	302	302	302	182	62	0	0	0	
1,675	1,700	184	64	0	0	3,700	3,750	566	558	434	432	431	311	311	311	191	71	0	0	0	
1,700	1,725	188	68	0	0	3,750	3,800	575	567	443	441	440	320	320	320	200	80	0	0	0	
1,725	1,750	193	73	0	0	3,800	3,850	585	577	453	451	449	329	329	329	209	89	0	0	0	
1,750	1,775	197	77	0	0	3,850	3,900	595	586	463	460	458	338	338	338	218	98	0	0	0	
1,775	1,800	202	82	0	0	3,900	3,950	605	596	473	470	467	347	347	347	227	107	0	0	0	
1,800	1,825	206	86	0	0	3,950	4,000	615	605	483	479	476	356	356	356	236	116	0	0	0	
1,825	1,850	211	91	0	0	4,000	4,050	625	615	493	489	485	365	365	365	245	125	5	0	0	
1,850	1,875	215	95	0	0	4,050	4,100	635	624	503	498	494	374	374	374	254	134	14	0	0	
1,875	1,900	220	100	0	0	4,100	4,150	645	634	513	508	503	383	383	383	263	143	23	0	0	
1,900	1,925	224	104	0	0	4,150	4,200	655	643	523	517	512	392	392	392	272	152	32	0	0	
1,925	1,950	229	109	0	0	4,200	4,250	665	653	533	527	521	401	401	401	281	161	41	0	0	
1,950	1,975	233	113	0	0	4,250	4,300	674	662	542	536	530	410	410	410	290	170	50	0	0	
1,975	2,000	238	118	0	0	4,300	4,350	684	671	552	545	539	420	419	419	299	179	59	0	0	
2,000	2,025	242	122	2	0	4,350	4,400	694	681	562	555	548	430	429	428	308	188	68	0	0	
2,025	2,050	247	127	7	0	4,400	4,450	704	690	572	564	557	440	438	437	317	197	77	0	0	
2,050	2,075	251	131	11	0	4,450	4,500	714	700	582	574	566	450	448	446	326	206	86	0	0	
2,075	2,100	256	136	16	0	4,500	4,550	724	709	592	583	575	460	457	455	335	215	95	0	0	
2,100	2,125	260	140	20	0	4,550	4,600	734	719	602	593	584	470	467	464	344	224	104	0	0	
2,125	2,150	265	145	25	0	4,600	4,650	744	728	612	602	593	480	476	473	353	233	113	0	0	
2,150	2,175	269	149	29	0	4,650	4,700	754	738	622	612	602	490	486	482	362	242	122	2	0	
2,175	2,200	274	154	34	0	4,700	4,750	764	747	632	621	611	500	495	491	371	251	131	11	0	
2,200	2,225	278	158	38	0	4,750	4,800	773	756	641	630	620	509	504	500	380	260	140	20	0	
2,225	2,250	283	163	43	0	4,800	4,850	783	766	651	640	629	519	514	509	389	269	149	29	0	
2,250	2,275	287	167	47	0	4,850	4,900	793	775	661	649	638	529	523	518	398	278	158	38	0	
2,275	2,300	292	172	52	0	4,900	4,950	803	785	671	659	647	539	533	527	407	287	167	47	0	
2,300	2,325	296	176	56	0	4,950	5,000	813	794	681	668	656	549	542	536	416	296	176	56	0	

§ 1.3–1 Application of optional tax.

(a) *General rules.* (1) An individual whose adjusted gross income is less than $5,000 (or a husband and wife filing a joint return whose combined adjusted gross income is less than $5,000) may elect to pay the tax imposed by section 3 in place of the tax imposed by section 1 (a) or (b). See § 1.4–2 for the manner of making such election. A taxpayer may make such election regardless of the sources from which his income is derived and regardless of whether his income is computed by the cash method or the accrual method. See section 62 and the regulations thereunder for the determination of adjusted gross income. For the purpose of determining whether a taxpayer may elect to pay the tax under section 3, the amount of the adjusted gross income is controlling, without reference to the number of exemptions to which the taxpayer may be entitled. See section 4 and the regulations thereunder for additional rules applicable to section 3.

(2) The following examples illustrate the rule that section 3 applies only if the adjusted gross income is less than $5,000:

Example (1). A is employed at a salary of $4,600 for the calendar year 1954. In the course of such employment, he incurred travel expenses of $750 for which he was reimbursed during the year. Such items constitute his sole income for 1954. In such case the gross income is $5,350 but the amount of $750 is deducted from gross income in the determination of adjusted gross income and thus A's adjusted gross income for 1954 is $4,600. Hence, the adjusted gross income being less than $5,000, he may elect to pay his tax for 1954 under section 3. Similarly, in the case of an individual engaged in trade or business (excluding from the term "engaged in trade or business" the performance of personal services as an employee), there may be deducted from gross income in ascertaining adjusted gross income those expenses directly relating to the carrying on of such trade or business.

Example (2). If B has, as his only income for 1954, a salary of $5,800 and his spouse has no gross income, then B's adjusted gross income is $5,800 (not $5,800 reduced by exemptions of $1,200) and he is not, for such year, entitled to pay his tax under section 3. If, however, B has for 1954 a salary of $6,500 and incident to his employment he incurs expenses in the amount of $1,700 for travel, meals, and lodging while away from home, the adjusted gross income is $6,500 minus $1,700, or $4,800. In such case his adjusted gross income being less than $5,000, B may elect to pay the tax under section 3. However, if B's wife has adjusted gross income of $200, the total adjusted gross income is $5,000. In such case, if B and his wife file a joint return, they may not elect to pay the optional tax since the combined adjusted gross income is not less than $5,000. B may nevertheless elect to pay the optional tax, but if he makes this election he must file a separate return and, since his wife has gross income, he may not claim an exemption for her in computing the optional tax.

(b) *Surviving spouse.* The return of a surviving spouse is treated as a joint return for purposes of section 3. See section 2, and the regulations thereunder, with respect to the qualifications of a taxpayer as a surviving spouse. Accordingly, if the taxpayer qualifies as a surviving spouse and elects to pay the optional tax, he shall use the column in the tax table, appropriate to his number of exemptions, provided for cases in which a joint return is filed.

(c) *Use of tax table.* (1) To determine the amount of the tax, the individual ascertains the amount of his adjusted gross income, refers to the table set forth in section 3, ascertains the income bracket into which such income falls, and, using the number of exemptions applicable to his case, finds the tax in the vertical column having at the top thereof a number corresponding to the number of exemptions to which the taxpayer is entitled.

(2) The tax table in section 3 contains, in certain instances, double columns, in one of which is shown the tax if the taxpayer is single (and not the head of a household) or married and files a separate return, and in the other of which is shown the tax if the taxpayer is the head of a household. In other instances, such table contains triple columns, in the first of which is shown the tax if the taxpayer is single (and not the head of a household) or married and files a separate return, in the second of which is shown the tax if the taxpayer is the head of a household, and in the third of which is shown the tax if a joint return is filed. In the case of double or triple columns, the tax shall be determined by reference to the applicable column.

(3) The tax shown in the tax table set forth in section 3 reflects full income splitting in the case of a joint return (including the return of a surviving spouse) and lesser income splitting in

the case of a head of household. Therefore, it is possible for the tax shown in the column relating to a joint return, or relating to a return of a head of a household, to be lower than that shown in the separate return column even though the amounts of adjusted gross income and the number of exemptions are the same. For example, if H, a married man, has adjusted gross income of $4,925 for the calendar year 1954 and his wife has no gross income the tax on a joint return basis would be $647 (assuming he is entitled to only two exemptions). If H files a separate return, claiming two exemptions (himself and his wife), his tax would be $671.

(4) The determination of the tax by use of the tax table set forth in section 3 may be illustrated by the following examples:

Example (1). Assume that A has adjusted gross income for the calendar year 1954 of $4,225, has two exemptions, and is single and not a head of a household. The tax is $533, which amount appears in the table under the first of the columns for two exemptions (designated for single taxpayers or married taxpayers filing separate returns) and opposite the appropriate income bracket ($4,200 to $4,250) in the column showing adjusted gross income.

Example (2). Assume the same facts as in example (1) except that B qualifies as a head of a household. The tax is $527, which amount appears under the second of the columns for two exemptions (designated for a taxpayer who is a head of household) and opposite the appropriate income bracket ($4,200 to $4,250) in the column showing adjusted gross income.

§ 1.4 Statutory provisions; rules for optional tax.

SEC. 4. *Rules for optional tax*—(a) *Number of exemptions.* For purposes of the table in section 3, the term "number of exemptions" means the number of the exemptions allowed under section 151 as deductions in computing taxable income.

(b) *Manner of election.* The election referred to in section 3 shall be made in the manner provided in regulations prescribed by the Secretary or his delegate.

(c) *Husband or wife filing separate return.* A husband or wife may not elect to pay the optional tax imposed by section 3 if the tax of the other spouse is determined under section 1 on the basis of taxable income computed without regard to the standard deduction. For purposes of the preceding sentence, determination of marital status shall be made under section 143.

(d) *Certain other taxpayers ineligible.* Section 3 shall not apply to—

(1) A nonresident alien individual;

(2) A citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);

(3) An individual making a return under section 443 (a) (1) for a period of less than 12 months on account of a change in his accounting period; or

(4) An estate or trust.

(e) *Taxable income computed with standard deduction.* Whenever it is necessary to determine the taxable income of a taxpayer who made the election referred to in section 3, the taxable income shall be determined under section 63 (b) (relating to definition of taxable income for individuals electing standard deduction).

(f) *Cross references.* (1) For other applicable rules (including rules as to the change of an election under section 3), see section 144.

(2) For disallowance of certain credits against tax, see section 36.

§ 1.4–1 Number of exemptions.

(a) For the purpose of determining the optional tax imposed under section 3, the taxpayer shall use the number of exemptions allowable to him as deductions under section 151. See sections 151, 152, and 153, and the regulations thereunder. In general, one exemption is allowed for the taxpayer; one exemption for his spouse if a joint return is made, or if a separate return is made by the taxpayer and his spouse has no gross income for the calendar year in which the taxable year of the taxpayer begins and is not the dependent of another taxpayer for such calendar year; and one exemption for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600. No exemption is allowed for any dependent who has made a joint return with his spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. The taxpayer may, in certain cases, be allowed an exemption for a dependent child of the taxpayer notwithstanding the fact that such child has gross income of $600 or more. Additional exemptions are allowed for a taxpayer or spouse who has attained the age of 65 years and for a blind taxpayer or blind spouse.

(b) The application of this section may be illustrated by the following examples:

Example (1). A, a married man whose duties as an employee require traveling away from his home, has as his sole gross income a salary of $5,600 for the calendar year 1954. His traveling expenses, including cost of meals and lodging, amount in such year to $750, and, hence, his adjusted gross income is $4,850. His wife, B, has as her sole income interest in the amount of $85, and thus the aggregate adjusted gross income of A and B is $4,935. A has two dependent children neither of whom has any income. A and B file a joint return for 1954 on Form 1040. In such case four exemptions are allowable. The adjusted gross income falls within the tax bracket $4,900–4,950. By referring to such tax bracket in the tax table in section 3 and to the column headed "4" therein, the tax is found to be $407.

Example (2). C, a married man, has as his sole income in 1954 wages of $4,600, and has two dependent children neither of whom has any income. His wife, D, has adjusted gross income of $400. C files a separate return for 1954 and is entitled to claim three exemptions. C's income falls within the tax bracket $4,600–4,650 and hence, with three exemptions his tax is $480. No exemption is allowed with respect to D since D has gross income and a joint return was not filed.

Example (3). D, a married man with no dependents, attains the age of 65 on September 1, 1954. The aggregate adjusted gross income of D and his wife for 1954 is $4,840. D and his wife file a joint return for 1954 and are entitled to three exemptions, one for each taxpayer and one additional exemption for D because of his age. Since the adjusted gross income of D and his wife falls within the tax bracket $4,800–4,850, the tax on a joint return is $509.

§ 1.4–2 Elections.

(a) *Making of election.* The election to pay the optional tax imposed under section 3 shall be made by (1) filing a return (whether a separate return or a joint return) on Form 1040A, or (2) filing a return (whether a separate return or a joint return) on Form 1040 or Form 1040W and electing in such return, in accordance with the provisions of section 144 and the regulations thereunder, to take the standard deduction provided by section 141.

(b) *Election under section 3 and election of standard deduction.* Section 144 (a) and the regulations thereunder provide rules for treating an election to pay the tax under section 3 as an election to take the standard deduction, and for treating an election to take the standard deduction as an election to pay the tax under section 3. For example, if the taxpayer's return shows $5,000 or more of adjusted gross income and he elects to take the standard deduction, he will be deemed to have elected to pay the tax under section 3 if it is subsequently determined that his correct adjusted gross income is less than $5,000.

(c) *Head of household and surviving spouse.* In the case of a head of a household (as defined in section 1 (b) and the regulations thereunder) or a surviving spouse (as defined in section 2 (b) and the regulations thereunder) electing to make his return on Form 1040A, the tax imposed by section 3 shall be computed without regard to the status of the taxpayer as the head of a household or as a surviving spouse. See section 6014 and the regulations thereunder.

(d) *Change of election.* For rules relating to a change of election to pay, or not to pay, the optional tax imposed under section 3, see section 144 (b) and the regulations thereunder.

§ 1.4–3 Husband and wife filing separate returns.

(a) If the separate adjusted gross income of a husband is less than $5,000 and the separate adjusted gross income of his wife is less than $5,000, and if each is required to file a return, the husband and the wife both must, or neither can, elect to pay the optional tax imposed under section 3. If the separate adjusted gross income of each spouse is $5,000 or more, then neither spouse can elect to pay the optional tax imposed under section 3. If the adjusted gross income of one spouse is $5,000 or more and that of the other spouse is less than $5,000, the election to pay the optional tax imposed under section 3 may be exercised by the spouse having adjusted gross income of less than $5,000 only if the spouse having adjusted gross income of $5,000 or more, in computing taxable income, uses the standard deduction provided by section 141. If the spouse having adjusted gross income of $5,000 or more does not use the standard deduction, then the spouse having adjusted gross income of less than $5,000 may not elect to pay the optional tax and must compute taxable income without regard to the standard deduction. Accordingly, if the spouse having adjusted gross income of $5,000 or more itemizes the deductions allowed by sections 161 and 211 in computing taxable income, the spouse having adjusted gross income of less than $5,000 must also compute taxable income by itemizing the deductions allowed by sections 161 and 211, and must pay the tax imposed by section 1. For rules relative to the election to take the standard de-

duction by husband and wife, see part IV (section 141 and following), subchapter B, chapter 1 of the Code, and the regulations thereunder.

(b) For the purpose of applying the restrictions upon the right of a married person to elect to pay the tax under section 3, the determination of marital status is made as of the close of the taxpayer's taxable year or, if his spouse died during such year, as of the date of death, and a person legally separated from his spouse under a decree of divorce or separate maintenance on the last day of his taxable year (or the date of death of his spouse, whichever is applicable) is not considered married. See section 143 and the regulations thereunder.

§ 1.4–4 Short taxable year caused by death.

An individual making a return for a period of less than 12 months on account of a change in his accounting period may not elect to pay the optional tax under section 3. However, the fact that the taxable year is less than 12 months does not prevent the determination of the tax for the taxable year under section 3 if the short taxable year results from the death of the taxpayer.

§ 1.5 Statutory provisions; cross references relating to tax on individuals.

SEC. 5. *Cross references relating to tax on individuals*—(a) *Other rates of tax on individuals, etc.* (1) For rates of tax on nonresident aliens, see section 871.

(2) For doubling of tax on citizens of certain foreign countries, see section 891.

(3) For alternative tax in case of capital gain, see section 1201 (b).

(4) For rate of withholding in the case of nonresident alients, see ection 1441.

(b) *Special limitations on tax.* (1) For limitation on tax attributable to receipt of lump sum under annuity, endowment, or life insurance contract, see section 72 (e) (3).

(2) For limitation on surtax attributable to sales of oil or gas properties, see section 632.

(3) For limitation on tax in case of income of members of Armed Forces on death, see section 692.

(4) For limitation on tax with respect to compensation for long-term services, see section 1301.

(5) For limitation on tax with respect to income from artistic work or inventions, see section 1302.

(6) For limitation on tax in case of back pay, see section 1308.

(7) For computation of tax where taxpayer restores substantial amount held under claim of right, see section 1341.

(8) For limitation on surtax attributable to claims against the United States involving acquisitions of property, see section 1347.

TAX ON CORPORATIONS

§ 1.11 Statutory provisions; tax imposed.

SEC. 11. *Tax imposed*—(a) *Corporations in general.* A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) *Normal tax*—(1) *Taxable years beginning before July 1, 1961.* In the case of a taxable year beginning before July 1, 1961, the normal tax is equal to 30 percent of the taxable income.

(2) *Taxable years beginning after June 30, 1961.* In the case of a taxable year beginning before July 1, 1961, the normal tax is equal to 25 percent of the taxable income.

(c) *Surtax.* The surtax is equal to 22 percent of the amount by which the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) exceeds $25,000.

(d) *Exceptions.* Subsection (a) shall not apply to a corporation subject to a tax imposed by—

(1) Section 594 (relating to mutual savings banks conducting life insurance business),

(2) Subchapter L (sec. 801 and following, relating to insurance companies),

(3) Subchapter M (sec. 851 and following, relating to regulated investment companies), or

(4) Section 881 (a) (relating to foreign corporations not engaged in business in United States).

[Sec. 11 as amended by sec. 2, Tax Rate Extension Act 1955 (69 Stat. 14); sec. 2, Tax Rate Extension Act 1956 (70 Stat. 66); sec. 2, Tax Rate Extension Act 1957 (71 Stat. 9); sec. 2, Tax Rate Extension Act 1958 (72 Stat. 259); sec. 2, Tax Rate Extension Act 1959 (73 Stat. 157); sec. 201, Public Debt and Tax Rate Extension Act 1960 (74 Stat. 290)]

§ 1.11–1 Tax on corporations.

(a) Every corporation, foreign or domestic, is liable to the tax imposed under section 11 except (1) corporations described in section 11(d); (2) corporations expressly exempt from all taxation under subtitle A of the Code (see section 501); and (3) corporations subject to tax under section 511(a). For definition of the terms "corporation", "domestic", and "foreign", see section 7701(a) (3), (4), and (5), respectively. It is immaterial that a domestic corporation subject to the tax imposed by section 11 may derive no income from sources within the United States. The tax imposed by section 11 is payable upon the basis of returns rendered by the corporations liable thereto, except that in some cases a tax is to be paid at the source of the income. See subchapter A (section 6001 and following), chapter 61 of the Code, and section 1442.

(b) The tax imposed by section 11 consists of a normal tax and a surtax. The normal tax and the surtax are both computed upon the taxable income of the corporation for the taxable year, that is, upon the gross income of the corporation minus the deductions allowed by chapter 1 of the Code. However, the deduction provided in section 242 for partially tax-exempt interest is not allowed in computing the taxable income subject to the surtax.

(c) The normal tax is computed by applying to the taxable income the rate of tax in effect for the taxable year. The rates of tax applicable for the respective taxable years are as follows:

	Percent
For taxable years beginning before July 1, 1961	30
For taxable years beginning after June 30, 1961	25

(d) The surtax is at the rate of 22 percent and is upon the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) in excess of $25,000. However, in certain circumstances the $25,000 exemption from surtax may be disallowed in whole or in part. See sections 269 and 1551 and the regulations thereunder.

(e) The computation of the tax on corporations imposed under section 11 may be illustrated by the following example:

Example. The X Corporation, a domestic corporation, has gross income of $86,000 for the calendar year 1955. The gross income includes interest of $5,000 on United States obligations for which a deduction under section 242 is allowable in determining taxable income subject to the normal tax. It has other deductions of $11,000. The tax of the X Corporation under section 11 for the calendar year 1955 is $32,000 ($21,000 normal tax and $11,000 surtax) computed as follows:

Computation of Normal Tax

Gross income		$86,000
Deductions:		
Partially tax-exempt interest	$5,000	
Other	11,000	16,000
Taxable income		70,000
Normal tax (30 percent of $70,000)		21,000

Computation of Surtax

Taxable income	$70,000
Add: Amount of partially tax-exempt interest deducted in computing taxable income	5,000
Taxable income subject to surtax	75,000
Less: Exemption from surtax	25,000
Excess of taxable income subject to surtax over exemption	50,000
Surtax (22 percent of $50,000)	11,000

(f) For special rules applicable to foreign corporations engaged in trade or business within the United States, see section 882 and the regulations thereunder. For additional tax on personal holding companies, see part II (section 541 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For additional tax on corporations improperly accumulating surplus, see part I (section 531 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder. For treatment of China Trade Act corporations, see sections 941 and 942 and the regulations thereunder. For treatment of Western Hemisphere trade corporations, see sections 921 and 922 and the regulations thereunder. For treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code,. For computation of the tax for a taxable year during which a change in the tax rates occurs, see section 21 and the regulations thereunder.

§ 1.12 Statutory provisions; cross references relating to tax on corporations.

SEC. 12. *Cross references relating to tax on corporations.* (1) For tax on the unrelated business income of certain charitable and other corporations exempt from tax under this chapter, see section 511.

(2) For accumulated earnings tax and personal holding company tax, see parts I and II of subchapter G (sec. 531 and following).

(3) For doubling of tax on corporations of certain foreign countries, see section 891.

(4) For alternative tax in case of capital gains, see section 1201 (a).

(5) For rate of withholding in case of foreign corporations, see section 1442.

(6) For withholding of tax on tax-free covenant bonds, see section 1451.

(7) For limitation on the $25,000 exemption from surtax provided in section 11 (c) see section 1551.

(8) For additional tax for corporations filing consolidated returns, see section 1503.

CHANGES IN RATES DURING A TAXABLE YEAR

§ 1.21 Statutory provisions; effect of changes.

SEC. 21. *Effect of changes*—(a) *General rule.* If any rate of tax imposed by this chapter changes, and if the taxable year includes the effective date of the change (unless that date is the first day of the taxable year), then—

(1) Tentative taxes shall be computed by applying the rate for the period before the effective date of the change, and the rate for the period on and after such date, to the taxable income for the entire taxable year; and

(2) The tax for such taxable year shall be the sum of that proportion of each tentative tax which the number of days in each period bears to the number of days in the entire taxable year.

(b) *Repeal of tax.* For purposes of subsection (a)—

(1) If a tax is repealed, the repeal shall be considered a change of rate; and

(2) The rate for the period after the repeal shall be zero.

(c) *Effective date of change.* For purposes of subsections (a) and (b)—

(1) If the rate changes for taxable years "beginning after" or "ending after" a certain date, the following day shall be considered the effective date of the change; and

(2) If a rate changes for taxable years "beginning on or after" a certain date, that date shall be considered the effective date of the change.

(d) *Taxable years beginning before January 1, 1954, and ending after December 31, 1953.* In the case of a taxable year beginning before January 1, 1954, and ending after December 31, 1953—

(1) Subsection (a) of this section does not apply; and

(2) In the application of subsection (j) of section 108 of the Internal Revenue Code of 1939, the provisions of such code referred to in such subsection shall be considered as continuing in effect as if this subtitle had not been enacted.

§ 1.21–1 Changes in rate during a taxable year.

(a) Section 21 applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where (1) any rate of tax imposed by chapter 1 of the Code upon the taxpayer is increased or decreased, or any such tax is repealed, and (2) the taxable year includes the effective date of the change, except where that date is the first day of the taxable year. Thus, for example, the normal tax on corporations might, under section 11(b), be decreased from 30 percent to 25 percent in the case of a taxable year beginning after June 30. Accordingly, the tax for a taxable year of a corporation beginning on July 1 would be computed under section 11(b) at the new rate without regard to section 21. However, for any taxable year beginning before July 1, and ending on or after that date, the tax would be computed under section 21. For additional circumstances under which section 21 is not applicable, see paragraph (k) of this section.

(b) In any case in which section 21 is applicable, a tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year before the effective date of change, and another tentative tax shall be computed by applying to the taxable income for the entire taxable year the rate for the period within the taxable year on or after such effective date. The tax imposed on the taxpayer is the sum of—

(1) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year before the effective date of the change that the number of days in such period bears to the number of days in the taxable year, and

(2) An amount which bears the same ratio to the tentative tax computed at the rate applicable to the period within the taxable year on and after the effective date of the change that the number of days in such period bears to the number of days in the taxable year.

(c) If the rate of tax is changed for taxable years "beginning after" or "ending after" a certain date, the following day is considered the effective date of the change for purposes of section 21. If the rate is changed for taxable years "beginning on or after" a certain date, that date is considered the effective date of the change for purposes of section 21. This rule may be illustrated by the following examples:

Example (1). Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning after March 31, 1956. The effective date of change for purposes of section 21 is April 1, 1956, and section 21 must be applied to any taxable year which begins before and ends on or after April 1, 1956.

Example (2). Assume that the law provides that a change in a certain rate of tax shall be applicable only with respect to taxable years ending after March 31, 1956. For purposes of section 21, the effective date of change is April 1, 1956, and section 21 must be applied to any taxable year which begins before and ends on or after April 1, 1956.

Example (3). Assume that the law provides that a change in a certain rate of tax shall be effective only with respect to taxable years beginning on or after January 1, 1956. The effective date of change for purposes of section 21 is January 1, 1956, and section 21 must be applied to any taxable year which begins before and ends on or after January 1, 1956.

(d) If a tax is repealed, the repeal will be treated as a change of rate for purposes of section 21, and the rate for the period after the repeal (for the purpose of computing the tentative tax in respect to that period) will be considered zero. However, section 21 does not apply to the imposition of a new tax. For example, if a new tax is imposed for taxable years beginning on or after July 1, 1955, a computation under section 21 would not be required with respect to such new tax in the case of taxable years beginning before July 1, 1955, and ending on or after that date. If the effective date of the imposition of a new tax and the effective date of a change in rate of such tax fall in the same taxable year, section 21 is not applicable in computing the taxpayer's liability for such tax for such year unless the new tax is expressly imposed upon the taxpayer for a portion of his taxable year prior to the change in rate.

(e) If a husband and wife have different taxable years because of the death of either spouse, and if a joint return is filed with respect to the taxable year of each, then, for purposes of section 21, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year. See section 6013 (c), relating to treatment of joint return after death of either spouse. Accordingly, if a change in the rate of tax is effective during the taxable year of the surviving spouse, the tentative taxes with respect to the joint return shall be computed on the basis of the number of days during which each rate of tax was in effect for the taxable year of the surviving spouse.

(f) Section 21 applies whether or not the taxpayer has a taxable year of less than 12 months. Moreover, section 21 applies whether or not the taxable income for a taxable year of less than 12 months is required to be placed on an annual basis under section 443. If the taxable income is required to be computed under section 443 (b) then the tentative taxes under section 21 are computed as provided in paragraph (1) or (2) of section 443 (b) and are reduced as provided in those paragraphs. The tentative taxes so computed and reduced are then apportioned as provided in section 21 (a) (2) to determine the tax for such taxable year as computed under section 21.

(g) If a taxpayer has made the election under section 441 (f) (relating to computation of taxable income on the basis of an annual accounting period varying from 52 to 53 weeks), the rules provided in section 441 (f) (2) shall be applicable for purposes of determining whether section 21 applies to the taxable year of the taxpayer. Where a taxpayer has made the election under section 441 (f) and where section 21 applies to the taxable year of the taxpayer the computation under section 21 (a) (2) shall be made upon the basis of the actual number of days in the taxable year and in each period thereof.

(h) (1) Section 21 is applicable only if a rate of tax imposed by chapter 1 of the Code changes. Sections in which rates of tax are specified or incorporated by reference include the following: 1, 2, 3, 11, 511, 531, 541, 871, 881, and 1201. Section 21 is not applicable with respect to changes in the law relating to deductions from gross income, exclusions from or inclusions in gross income, or other items taken into account in determining the amount or character of income subject to tax. Moreover, section 21 is not applicable with respect to changes in the law relating to credits against the tax or with respect to changes in the law relating to limitations on the amount of tax. Section 21 is applicable, however, to all those computations specified in the section providing the rate of tax which are implicit in determining the rate. For example, if one of the tax brackets in section 1 (b) (1) is changed, section 21 is applicable to that change. Thus, if the bracket relating to "over $50,000 but not over $60,000" should be changed to increase the last sum specified, with corresponding changes being made in subsequent brackets, section 21 is applicable. Another example would be if the $25,000 amount specified in section 11 (c) were changed. Even

though there were no other change in section 11 (c), this change would be considered a change in rate.

(2) Ordinarily, both the old and the new rates are applied to the same amount of taxable income. However, where the rate of tax is itself taken into account in determining taxable income (for example, the special deduction for Western Hemisphere trade corporations under section 922), the taxable income used in determining the tentative tax employing the rate before the effective date of change shall be determined by reference to that rate of tax, and the taxable income for the purpose of determining the tentative tax employing the rate for the period on and after the effective date of the change shall be determined by reference to the new tax rate.

(i) If the rate of tax changes more than once during the taxable year, section 21 is applicable to each change in rate. For example, if the rate of normal tax changed for taxable years beginning on or after March 1, 1954, and changed again for taxable years beginning on or after June 1, 1954, section 21 requires computation of 3 tentative taxes for any taxable year which began before March 1, 1954, and ended on or after June 1, 1954: One tentative tax at the rate in effect before the March 1 change; another tentative tax at the rate in effect from March 1 to May 31; and a third tentative tax at the rate in effect from June 1 to the end of the taxable year. The proportion of each such tentative tax taken into account in determining the tax imposed on the taxpayer is computed by reference to the portion of the taxable year before March 1, 1954, by reference to the portion of the taxable year from March 1, 1954, through May 31, 1954, and by reference to the portion of the taxable year from June 1, 1954, to the end of the taxable year, respectively.

(j) (1) If a change in the rate of one tax imposed by chapter 1 of the Code does not affect the amount of other taxes imposed by chapter 1 of the Code the other taxes may be determined without regard to section 21 and section 21 will be applied only to the tax for which a change in rate is made. However, if the change of rate of one tax does affect the amount of other taxes imposed under chapter 1 of the Code, then the computation of the taxes under chapter 1 of the Code so affected shall be made by applying section 21. For example, if section 1201 applies to an individual taxpayer for a taxable year containing the effective date of a change in a rate of tax provided in section 1, then under section 21 the taxpayer must compute a tentative tax for each period for which a different rate of tax is effective under section 1. The tentative tax for each such period as computed under section 1201 will reflect the rate of tax provided by section 1 for such period.

(2) In certain cases chapter 1 of the Code provides that the particular tax to be imposed upon the taxpayer shall be one of several taxes, the basis of selection being the tax that is greater or lesser. See, for example, sections 821 and 1201. If in any such case the rate of any one of these taxes changes, then the tentative taxes computed as provided by section 21 for each period shall be computed employing the tax selected in accordance with the general rule of selection for such a case, at the rate of tax in effect for such period. Thus, if a change in the rate of the alternative tax under section 1201 is such that the alternative tax under section 1201 is applicable if the old rate is used and is not applicable if the new rate is used, one tentative tax will consist of the alternative tax under section 1201 and the other tentative tax will consist of the tax imposed by the other applicable sections of chapter 1 of the Code. The two tentative taxes so computed are then prorated in accordance with section 21(a)(2) and the sum of the proportionate amounts is the tax imposed for the taxable year under chapter 1 of the Code. See the examples in paragraph (n) of this section.

(k) Section 21 does not apply in the following two situations:

(1) Section 1201 (a) (2), relating to the alternative tax for capital gains in case of a corporation, provides a different rate of tax for a taxable year beginning before April 1, 1954, than the rate of tax applicable to a taxable year beginning on or after April 1, 1954.

(2) The provisions of section 21 do not apply in the case of any taxpayer for taxable years beginning before January 1, 1954, and ending after December 31, 1953. For such taxable years, section 21 provides that section 108 (j) of the Internal Revenue Code of 1939, relating to individuals, shall continue to be applicable, and the tax shall be computed at the rate and in the manner set forth in 26 CFR (1939) 39.108–1 (Regulations 118).

(l) In computing the number of days each rate of tax is in effect during the taxable year for purposes of section 21 (a) (2), the effective date of the change in rate shall be counted in the period for which the new rate is in effect.

(m) Any credits against tax, and any limitation in any credit against tax, shall be based upon the tax computed under section 21. For credits against tax, see part IV (section 31 and following), subchapter A, chapter 1 of the Code.

(n) The application of section 21 may be illustrated by the following examples:

Example (1). A, an individual filing his return on a calendar year basis, has taxable income for the calendar year 1955, in the amount of $22,000 which includes $4,000 representing 50 percent of a long-term capital gain of $8,000. Assume, for the purpose of this example, that there has been no change in the rates of tax as shown in the tax table under section 1 (a), but the tax on capital gains under section 1201 (b), relating to the alternative tax, has been increased from 25 percent to 35 percent and the effective date of the change in rate is July 1, 1955. The change in the rate of the capital gains tax affects a choice between the use of the tax table under section 1 and the alternative tax computation under section 1201 (b). Accordingly, the first tentative tax would consist of the alternative tax under section 1201 (b) and the second tentative tax would consist of the normal tax and surtax as computed by the use of the tax table under section 1. The income tax for the taxable year ended December 31, 1955, would be computed under section 21 as follows:

First tentative tax

Taxable income (including 50 percent of long-term capital gain)	$22,000
Less: 50 percent of long-term capital gain	4,000
Amount taxable by use of tax table under section 1	18,000
Tax on $18,000 (from tax table under section 1)	6,200
25 percent of long-term capital gain of $8,000	2,000
Total tentative tax at rates effective prior to change	8,200

Second tentative tax

Tax on $22,000 (from tax table under section 1)	8,380
Total tentative tax at rates effective on and after effective date of change	$8,380

Since the effective date of the change is July 1, the old rate of tax is effective for 181 days of the taxable year and the new rate of tax is effective for 184 days of the taxable year. The tentative taxes are apportioned as follows:

181/365 of $8,200 (the first tentative tax)	$4,066.30
184/365 of $8,380 (the second tentative tax)	4,224.44
Total tax for the taxable year	8,290.74

Example (2). For purposes of this example, the following facts are assumed: The taxpayer is a corporation, its taxable year is a calendar year of 365 days (that is, it is not a leap year), its taxable income for both normal tax and surtax purposes is $100,000, and it is subject to a change in the rate of the normal tax from 30 percent of taxable income to 25 percent of taxable income effective on July 1 of the taxable year. The change in the normal tax rate applicable to the corporation does not affect the amount of any other tax applicable to the corporation under chapter 1 of the Code. In such case, the tentative tax at the 30 percent rate would be $30,000, and the tentative tax at the 25 percent rate would be $25,000. The proportionate part of the tentative tax at the 30 percent rate is $14,876.71, that is, an amount which is the same proportion of $30,000 as 181 (the number of days from January 1 to June 30 of the taxable year, both dates inclusive) is to 365 (the total number of days in the taxable year). The proportionate part of the tentative tax at the 25 percent rate is $12,602.74, that is, an amount which is the same proportion of $25,000 as 184 (the number of days from July 1 to December 31 of the taxable year, both dates inclusive) is to 365.

CREDITS AGAINST TAX

§ 1.31 Statutory provisions; tax withheld on wages.

SEC. 31. *Tax withheld on wages*—(a) *Wage withholding for income tax purposes*—(1) *In general.* The amount withheld under section 3402 as tax on the wages of any individual shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

(2) *Year of credit.* The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

(b) *Credit for special refunds of social security tax*—(1) *In general.* The Secretary

or his delegate may prescribe regulations providing for the crediting against the tax imposed by this subtitle of the amount determined by the taxpayer or the Secretary (or his delegate) to be allowable under section 6413 (c) as a special refund of tax imposed on wages. The amount allowed as a credit under such regulations shall, for purposes of this subtitle, be considered an amount withheld at source as tax under section 3402.

(2) *Year of credit.* Any amount to which paragraph (1) applies shall be allowed as a credit for the taxable year beginning in the calendar year during which the wages were received. If more than one taxable year begins in the calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

§ 1.31–1 Credit for tax withheld on wages.

(a) The tax deducted and withheld at the source upon wages under chapter 24 of the Internal Revenue Code of 1954 (or in the case of amounts withheld in 1954, under subchapter D, chapter 9 of the Internal Revenue Code of 1939) is allowable as a credit against the tax imposed by subtitle A of the Internal Revenue Code of 1954, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

(b) The tax withheld during any calendar year shall be allowed as a credit against the tax imposed by subtitle A for the taxable year of the recipient of the income which begins in that calendar year. If such recipient has more than one taxable year beginning in that calendar year, the credit shall be allowed against the tax for the last taxable year so beginning.

§ 1.31–2 Credit for "special refunds" of employee social security tax.

(a) *In general.* (1) In the case of an employee receiving wages from more than one employer during the calendar year, amounts may be deducted and withheld as employee social security tax with respect to more than $3,600 of wages received during the calendar year 1954, and with respect to more than $4,200 of wages received during a calendar year after 1954. For example, employee social security tax may be deducted and withheld on $5,000 of wages received by an employee during a particular calendar year if the employee is paid wages in such year in the amount of $3,000 by one employer and in the amount of $2,000 by another employer. Section 6413 (c) (as amended by section 202 of the Social Security Amendments of 1954 (68 Stat. 1089)), permits, under certain conditions, a so-called "special refund" of the amount of employee social security tax deducted and withheld with respect to wages paid to an employee in a calendar year after 1954 in excess of $4,200 ($3,600 for the calendar year 1954) by reason of the employee receiving wages from more than one employer during the calendar year. For provisions relating to the imposition of the employee tax and the limitation on wages, see with respect to the calendar year 1954, sections 1400 and 1426(a)(1) of the Internal Revenue Code of 1939 and, with respect to calendar years after 1954, sections 3101 and 3121 (a) (1) of the Internal Revenue Code of 1954, as amended by sections 208 (b) and 204 (a), respectively, of the Social Security Amendments of 1954 (68 Stat. 1094, 1091).

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year (or for his last taxable year beginning in such calendar year) may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source. For provisions for claiming special refunds for 1955 and subsequent years in the case of employees not required to file income tax returns, see section 6413 (c) and the regulations thereunder. For provisions relating to such refunds for 1954, see 26 CFR (1939) § 408.802 (Regulations 128).

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under chapter 24 of the Internal Revenue Code of 1954 (or, in the case of a special refund for 1954, subchapter D, chapter 9 of the Internal Revenue Code of 1939). If the amount of such special refund when added to amounts deducted and withheld as income tax exceeds the taxes imposed by subtitle A of the Internal Revenue Code of 1954, the amount of the excess constitutes an overpayment of income tax under subtitle A, and interest on such overpayment is allowed to the extent provided under section 6611 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 6401 (b).

(b) *Federal and State employees and employees of certain foreign corporations.* The provisions of this section shall apply to the amount of a special refund allowable to an employee of a Federal agency or a wholly owned instrumentality of the United States, to the amount of a special refund allowable to an employee of any State or political subdivision thereof (or any instrumentality of any one or more of the foregoing), and to the amount of a special refund allowable to employees of certain foreign corporations. See, with respect to such special refunds for 1954, section 1401 (d) (4) of the Internal Revenue Code of 1939, and with respect to such special refunds for 1955 and subsequent years, section 6413 (c) (2) of the Internal Revenue Code of 1954, as amended by section 202 of the Social Security amendments of 1954.

§ 1.32 Statutory provisions; tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds.

SEC. 32. *Tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds.* There shall be allowed as credits against the tax imposed by this chapter—

(1) The amount of tax withheld at source under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and on foreign corporations), and

(2) The amount of tax withheld at source under subchapter B of chapter 3 (relating to interest on tax-free covenant bonds).

§ 1.33 Statutory provisions; taxes of foreign countries and possessions of the United States.

SEC. 33. *Taxes of foreign countries and possessions of the United States.* The amount of taxes imposed by foreign countries and possessions of the United States shall be allowed as a credit against the tax imposed by this chapter to the extent provided in section 901.

§ 1.34 Statutory provisions; dividends received by individuals.

SEC. 34. *Dividends received by individuals*—(a) *General rule.* Effective with respect to taxable years ending after July 31, 1954, there shall be allowed to an individual, as a credit against the tax imposed by this subtitle for the taxable year, an amount equal to 4 percent of the dividends which are received after July 31, 1954, from domestic corporations and are included in gross income.

(b) *Limitation on amount of credit.* The credit allowed by subsection (a) shall not exceed whichever of the following is the lesser:

(1) The amount of the tax imposed by this chapter for the taxable year, reduced by the credit allowable under section 33 (relating to foreign tax credit); or

(2) The following percent of the taxable income for the taxable year:

(A) 2 percent, in the case of a taxable year ending before January 1, 1955.

(B) 4 percent, in the case of a taxable year ending after December 31, 1954.

(c) *No credit allowed for dividends from certain corporations.* Subsection (a) shall not apply to any dividend from—

(1) An insurance company subject to a tax imposed by part I or II of subchapter L (sec. 801 and following);

(2) A corporation organized under the China Trade Act, 1922 (see sec. 941); or

(3) A corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) A corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(d) *Special rules for certain distributions.* For purposes of subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

(e) *Certain nonresident aliens ineligible for credit.* No credit shall be allowed under

subsection (a) to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a).

(f) *Cross references.* (1) For exclusion of certain dividends from gross income, see section 116.

(2) For special rules relating to the credit provided by subsection (a), see sections 642 (trusts and estates), 702 (partnerships) and 584 (common trust funds).

(3) For disallowance of credit where tax is computed by Secretary or his delegate, see section 6014.

§ 1.34–1 Credit against tax and exclusion from gross income in case of dividends received by individuals.

(a) *In general.* (1) Section 34 provides a credit against the income tax of an individual for certain dividends received after July 31, 1954. The credit, subject to the limitations provided in section 34 (b), is equal to 4 percent of the dividends received. The credit is allowable with respect to dividends received in any taxable year ending after July 31, 1954. The credit applies only to dividends which are received from domestic corporations and which are included in the gross income of the taxpayer. Section 116 provides for the exclusion from gross income of the first $50 of certain dividends received by an individual. See § 1.116–1. In determining which dividends are entitled to the credit against income tax provided by section 34, the exclusion from gross income provided in section 116 is applied to the first dividends received in the taxable year. Since the exclusion applies to dividends received at any time during a taxable year ending after July 31, 1954, dividends received before August 1, 1954, may be taken into account in determining the exclusion from gross income under section 116 but do not constitute dividends for which a credit is allowed.

(2) The application of section 34 (without regard to the limitations provided in section 34 (b)) may be illustrated by the following example:

Example. A, an individual who makes his return on the basis of the calendar year, receives in the year 1954 the following dividends: $100 on March 1, $100 on June 1, $100 on September 1, and $100 on December 1. $50 of the dividends received by A on March 1, 1954, is excluded from gross income under section 116. The balance of the dividends received in 1954, amounting to $350, is includible in the gross income of A. Subject to the limitation in section 34 (b) a credit of $8 is allowed under section 34 (4 percent of $200, the amount of the dividends received after July 31, 1954, that is, $100 received on September 1, 1954, and $100 received on December 1, 1954).

(b) *Tax credit.* The credit is used to reduce the tax imposed by subtitle A of the Code, including the alternative tax under section 1201 in the case of capital gains and the self-employment tax under chapter 2 of the Code; however, it may not be used by the taxpayer as a credit against penalties, additions to the tax, or interest on delinquent taxes.

(c) *Joint return of husband and wife.* (1) In the case of a joint return the credit is determined on the basis of the dividends received by both the husband and wife after taking into account the exclusion allowed by section 116. See § 1.116–1. The credit is allowable in the case of a joint return on account of the dividends received by each spouse without regard to whether the spouse would be liable for the tax imposed by subtitle A if the joint return had not been filed. However, the limitations on amount of credit in section 34 (b) are determined by reference to the tax and the credit under section 33 required to be shown on the joint return and to the combined taxable income of husband and wife. For this purpose, it makes no difference whether the tax, the credit, or the taxable income is attributable to one or the other spouse. If both the husband and wife are entitled to the credit, their combined credit shall not exceed the amount so computed.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). H and W, husband and wife, make a joint return for the calendar year 1954. The only dividend received by either of them during the year is a dividend received by H on September 1 in the amount of $400. Subject to the limitations of section 34 (b), the credit amounts to $14 (4 percent of $350, the dividends included in gross income after allowance of the exclusion of $50 under section 116).

Example (2). The facts are the same as in example (1) except that W also received a dividend on September 1 of $30. Since this dividend (being less than the maximum amount allowable as an exclusion under section 116 (a)) is excluded from W's gross income, it does not affect the computation of the tax credit and the tax credit is the same as in example (1).

Example (3). H and W, husband and wife, make a joint return for the calendar year 1954. H and W each received a $400 dividend on September 1, 1954, and these were the only dividends received by them in 1954. Since H and W may each exclude $50 of the dividends received by them, $700 of dividend income is included in gross income. Subject to the limitations in section 34 (b), the credit against the tax of H and W amounts to $28 (4 percent of $700).

(d) *Individuals receiving dividends.* Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(e) *Time dividends are received.* In cases where it is necessary to determine the time of receipt of dividends, the rules established to determine in which taxable year dividends must be included in gross income apply, including the rules relating to constructive receipt. See section 451 and regulations thereunder.

§ 1.34–2 Limitations on amount of credit.

(a) Under section 34(b) the credit may not exceed the lesser of either—

(1) The amount of the tax imposed by chapter 1 of the Code for the taxable year reduced by the foreign tax credit allowable under section 33, or

(2) Whichever of the following is applicable:

(i) In the case of a taxable year ending before January 1, 1955, 2 percent of the taxable income for such taxable year;

(ii) In the case of a taxable year ending after December 31, 1954, 4 percent of the taxable income for such taxable year.

In the case of a taxpayer who computes his tax under section 3 or who uses the standard deduction provided by section 141, the taxable income for the taxable year is the adjusted gross income for the taxable year reduced by the standard deduction prescribed in section 141 and the deductions for personal exemptions provided in section 151. Where the alternative tax on capital gains is imposed under section 1201 (b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) The application of the limitations in paragraph (a) of this section may be illustrated by the following example:

Example. Assume the following facts in the case of an individual whose taxable year is the calendar year:

1954

Computation of tax liability without regard to the dividend received credit:	
(1) Gross income	$7,500
(2) Deductions	2,900
(3) Taxable income	4,600
(4) Income tax liability	996
(5) Foreign tax credit	16
(6) Income tax liability minus foreign tax credit	980
Computation of limitation under section 34 (b) (1):	
(7) Dividends for which credit is allowable	$2,500
(8) Dividends received credit under section 34 (a); (2,500×0.04)	100
(9) Dividends received credit, as limited by section 34 (b) (1); (item (6) or item (8) whichever is lesser)	100
Computation of limitation under section 34 (b) (2):	
(10) Taxable income	$4,600
(11) Dividends received credit under section 34 (b) (2); (4,600×0.02)	92
Dividends received credit allowable:	
Item (6), item (9), or item (11), whichever is lesser	$92

1955

Computation of tax liability without regard to the dividend received credit:	
(12) Gross income	$7,500
(13) Deductions	2,900
(14) Taxable income	4,600
(15) Income tax liability	996
(16) Foreign tax credit	816
(17) Income tax liability minus foreign tax credit	180
Computation of limitation under section 34 (b) (1):	
(18) Dividends for which credit is allowable	$2,500
(19) Dividends received credit under section 34 (a); (2,500×0.04)	100
(20) Dividends received credit as limited by section 34 (b) (1); (item (17) or item (19) whichever is lesser)	100
Computation of limitation under section 34 (b) (2):	
(21) Taxable income	$4,600

(22) Dividends received credit under section 34 (b) (2); (4,600 × 0.04)	$184
Dividends received credit allowable: Item (17), item (19), or item (22), whichever is lesser	$100

§ 1.34–3 Dividends to which the credit and exclusion apply.

(a) *General rule.* The credit under section 34 and the exclusion under section 116 apply only to distributions of property defined as dividends by section 316. Thus, the credit and the exclusion are not allowed with respect to patronage dividends paid by either exempt or taxable farm cooperatives. Nor are they allowed for distributions to nonstockholding policyholders by an insurance company having shares of stock or for any distribution by a mutual insurance company. See paragraph (b) of this section for an additional restriction with respect to stock life insurance companies. The credit and the exclusion are, however, allowed with respect to dividends paid on capital stock by nonexempt cooperatives and with respect to dividends paid on capital stock by building and loan associations. However, see paragraph (b) of this section with respect to so-called dividends paid by building and loan associations ineligible for the credit and the exclusion. The credit and the exclusion are allowed with respect to distributions from any organization taxed as a corporation if the distribution falls within the definition of a dividend in section 316.

(b) *Dividends from certain corporations.* (1) Section 34 (c) and (d) contains further restrictions on the type of distributions which are treated as dividends for purposes of the credit and exclusion. Thus, no credit or exclusion is applicable with respect to dividends received from a corporation organized under the China Trade Act, 1922 (15 U.S.C. 141); from stock life insurance companies; from corporations which during their taxable year of the distribution or their preceding taxable year were corporations to which section 931 applies (relating to income from sources within possessions of the United States); from corporations which during the taxable year of the distribution or the preceding taxable year are corporations exempt from tax either under section 501, relating to charitable, etc., organizations, or under section 521, relating to farmers' cooperative associations.

(2) So-called dividends paid by mutual savings banks, cooperative banks, and building and loan associations which are allowed as a deduction under section 591 are ineligible for the credit and exclusion.

(3) For special rules as to the limitation on the amount of dividends for which a credit and exclusion are allowable in the case of dividends paid by a regulated investment company, see section 854 and the regulations thereunder.

§ 1.34–4 Taxpayers not entitled to credit and exclusion.

(a) The credit or exclusion is not available to nonresident aliens with respect to whom a tax is imposed for the taxable year under section 871(a). If the taxpayer elects under section 6014 to have the Government compute his tax, the credit is not taken into account in such computation although the taxpayer is allowed the exclusion under section 116.

(b) For treatment of dividends received by estates or trusts, and the allocation of such dividends between an estate or trust and the beneficiary thereof, see sections 642, 652, and 662 and the regulations thereunder.

(c) For treatment of dividends received by a partnership see section 702 and the regulations thereunder.

(d) For treatment of dividends received by a common trust fund, see section 584 and the regulations thereunder.

§ 1.34–5 Effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §§ 1.34–1 to 1.34–4, inclusive, shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

§ 1.35 Statutory provisions; partially tax-exempt interest received by individuals.

SEC. 35. *Partially tax-exempt interest received by individuals*—(a) *In general.* There shall be allowed to an individual, as a credit against the tax imposed by this subtitle for the taxable year, an amount equal to 3 percent of the amount received as interest on obligations of the United States or on obligations of corporations organized under Act of Congress which are instrumentalities of the United States, but only if—

(1) Such interest is included in gross income; and

(2) Such interest is exempt from normal tax under the Act authorizing the issuance of such obligations.

(b) *Limitation on amount of credit.* The credit allowed by subsection (a) shall not exceed whichever of the following is the lesser:

(1) The amount of the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowable under sections 33 and 34, or

(2) 3 percent of the taxable income for the taxable year.

(c) *Certain nonresident aliens ineligible for credit.* No credit shall be allowed under subsection (a) to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871(a).

(d) *Cross reference.* For reduction of credit under this section on account of amortizable bond premium, see section 171.

[Sec. 35 as amended by sec. 41(b), Technical Amendments Act 1958 (72 Stat. 1639)]

§ 1.35–1 Partially tax-exempt interest received by individuals.

(a) The credit against tax under section 35 shall be allowed only to individuals and if the requirements of both paragraphs (1) and (2) of section 35(a) are met. Where the alternative tax on capital gains is imposed under section 1201(b), the taxable income for such taxable year is the taxable income as defined in section 63, which includes 50 percent of the excess of net long-term capital gain over net short-term capital loss.

(b) For the treatment of partially tax-exempt interest in the case of amounts not allocable to any beneficiary of an estate or trust, see section 642 (a)(1), and for treatment of amounts allocable to a beneficiary, see sections 652 and 662. For treatment of partially tax-exempt interest received by a partnership, see section 702 (a)(7). For treatment of such interest received by a common trust fund, see section 584 (c)(2).

(c) The application of section 35 may be illustrated by the following example:

Example. In his taxable year, 1955, A received $4,500 of partially tax-exempt interest. A's taxable income is $4,000 upon which the tax prior to any credits against tax is $840. His foreign tax credit under section 33 is $610, and his dividends received credit under section 34 is $120. A's credit under section 35 for partially tax-exempt interest is $110, determined as follows:

Section 35 (a)		
Partially tax-exempt interest		$4,500
Credit computed under section 35 (a); 3 percent of $4,500		135
Section 35 (b) (1)		
Tax imposed by chapter 1		$840
Less:		
Credit allowed under section 33	$610	
Credit allowed under section 34	120	
		730
Limitation on credit under section 35 (b)(1)		110
Section 35 (b) (2)		
Taxable income		$4,000
Limitation on credit under section 35 (b)(2); 3 percent of $4,000		120

Since of the three figures ($135, $110, and $120), the lesser is $110, A's credit under section 35 is limited to $110.

§ 1.35–2 Taxpayers not entitled to credit.

For taxable years beginning after December 31, 1957, no credit shall be allowed under section 35 to a nonresident alien individual with respect to whom a tax is imposed for such taxable year under section 871(a).

§ 1.36 Statutory provisions; credits not allowed to individuals paying optional tax or taking standard deduction.

SEC. 36. *Credits not allowed to individuals paying optional tax or taking standard deduction.* If an individual elects to pay the optional tax imposed by section 3, or if he elects under section 144 to take the standard deduction, the credits provided by sections 32, 33, and 35 shall not be allowed.

§ 1.37 Statutory provisions; retirement income.

SEC. 37. *Retirement income*—(a) *General rule.* In the case of an individual who has received earned income before the beginning of the taxable year, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the amount received by such individual as retirement income (as defined in subsection (c) and as limited by subsection (d)), multiplied by the rate provided in section 1 for the first $2,000 of taxable income; but this credit shall not exceed such tax reduced by the credits allowable under section 32 (2) (relating to tax withheld at source on tax-free covenant bonds), section

33 (relating to foreign tax credit), section 34 (relating to credit for dividends received by individuals), and section 35 (relating to partially tax exempt interest).

(b) *Individual who has received earned income.* For purposes of subsection (a), an individual shall be considered to have received earned income if he has received, in each of any 10 calendar years before the taxable year, earned income (as defined in subsection (g)) in excess of $600. A widow or widower whose spouse had received such earned income shall be considered to have received earned income.

(c) *Retirement income.* For purposes of subsection (a), the term "retirement income" means—

(1) In the case of an individual who has attained the age of 65 before the close of the taxable year, income from—

(A) Pensions and annuities,

(B) Interests,

(C) Rents, and

(D) Dividends, or

(2) In the case of an individual who has not attained the age of 65 before the close of the taxable year, income from pensions and annuities under a public retirement system (as defined in subsection (f)),

to the extent included in gross income without reference to this section, but only to the extent such income does not represent compensation for personal services rendered during the taxable year.

(d) *Limitation on retirement income.* For purposes of subsection (a), the amount of retirement income shall not exceed $1,200 less—

(1) In the case of any individual, any amount received by the individual as a pension or annuity—

(A) Under title II of the Social Security Act,

(B) Under the Railroad Retirement Acts of 1935 or 1937, or

(C) Otherwise excluded from gross income, and

(2) In the case of any individual who has not attained the age of 72 before the close of the taxable year, any amount of earned income (as defined in subsection (g))—

(A) In excess of $900 received by the individual in the taxable year if such individual has not attained the age of 65 before the close of the taxable year, or

(B) In excess of $1,200 received by the individual in the taxable year if such individual has attained the age of 65 before the close of the taxable year.

(e) *Rule for application of subsection (d) (1).* Subsection (d) (1) shall not apply to any amount excluded from gross income under section 72 (relating to annuities), 101 (relating to life insurance proceeds), 104 (relating to compensation for injuries or sickness), 105 (relating to amounts received under accident and health plans), 402 (relating to taxability of beneficiary of employees' trust), or 403 (relating to taxation of employee annuities).

(f) *Public retirement system defined.* For purposes of subsection (c) (2), the term "public retirement system" means a pension, annuity, retirement, or similar fund or system established by the United States, a State, a Territory, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia.

(g) *Earned income defined.* For purposes of subsections (b) and (d) (2), the term "earned income" has the meaning assigned to such term in section 911 (b), except that such term does not include any amount received as a pension or annuity.

(h) *Nonresident alien ineligible for credit.* No credit shall be allowed under subsection (a) to any nonresident alien.

(i) *Cross reference.* For disallowance of credit where tax is computed by Secretary or his delegate, see section 6014 (a).

[Sec. 37 as amended by Act of Aug. 9, 1955 (Pub. Law 299, 84th Cong., 69 Stat. 591); Act of Jan. 28, 1956 (Pub. Law 398, 84th Cong., 70 Stat. 8)]

§ 1.37–1 Allowance of credit for retirement income.

(a) Section 37 provides a credit against the tax imposed by chapter 1 of the Internal Revenue Code of 1954 in the case of an individual who receives in the taxable year retirement income as defined in section 37(c) and who meets the eligibility requirements of section 37(b). The amount of the credit is determined by multiplying the amount of retirement income, as limited by section 37(d), by the rate of tax applicable under section 1 to the first $2,000 of taxable income. Thus, if the retirement income is $1,000, the retirement income credit so computed is, at the present tax rate for the first $2,000 of taxable income, 20 percent of $1,000, or $200. The credit cannot exceed, however, the tax imposed by chapter 1, reduced by the credits enumerated in section 37(a).

(b) Section 37 (d) provides that the amount of retirement income with respect to which the retirement income credit is allowable can in no event exceed $1,200. Thus, the maximum credit for an individual cannot exceed $240 so long as section 1 provides a 20 percent rate for the first $2,000 of taxable income. If section 1 should be amended to change this rate, the amount of the credit and the maximum amount of credit would be changed accordingly.

(c) (1) Section 37 (a) provides that the amount of the retirement income credit shall not be greater than the excess of the individual's tax under chapter 1 of the Code for the taxable year over the sum of his credits against tax under section 32(2) (relating to tax withheld at source on tax-free covenant bonds), section 33 (relating to foreign tax credit), section 34 (relating to credit for dividends received by individuals), and section 35 (relating to partially tax-exempt interest).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that the individual has a retirement income credit of $240 before applying the limitation in section 37 (a), and has the tax liability shown in (i) below, and the credits shown in (ii) and (vi).

(i) Tax under chapter 1	$300
(ii) Sum of credits allowable under sections 32 (2), 33, 34, and 35	100
(iii) Tax reduced by credits in (ii)	200
(iv) Retirement income credit under section 37 (a) ($240 or $200 whichever is lesser)	200
(v) Tax under chapter 1 as further reduced by credit in (iv)	0
(vi) Credit for tax withheld at source on wages under section 31	35
(vii) Overpayment of tax	35

(d) (1) (i) In the case of a joint return of husband and wife, a separate determination is made with respect to the eligibility of each spouse for the retirement income credit, and (with the exceptions described in subdivision (ii) of this subparagraph) the retirement income credit of each spouse eligible for such credit is separately computed.

(ii) The retirement income credit is allowable in the case of a joint return on account of the retirement income of each spouse without regard to whether the spouse would be liable for the tax imposed by chapter 1 of the Code if the joint return had not been filed. For example, if the wife's only income consists of $500 of retirement income, and if she is eligible for the credit, the retirement income credit is allowable with respect to such retirement income in case a joint return is filed. However, the limitation in section 37 (a) on the amount of the credit is determined by reference to the tax and the credits under sections 32 (2), 33, 34, and 35, required to be shown on the joint return. For this purpose, it makes no difference whether the tax or the credits are attributable to one or the other spouse. If both the husband and wife are entitled to a retirement income credit, their combined retirement income credit shall not exceed the amount so computed.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Assume the same facts as in the example in paragraph (c) of this section, except that the return is a joint return, the retirement income credit is based on the retirement income of the husband only, the wife has no retirement income, and 90 percent of the amount shown as the tax under chapter 1 and the credits under sections 31, 32 (2), 33, 34, and 35 are attributable to the wife. The retirement income credit on the joint return is limited to $200, computed in exactly the same manner as shown in the example in paragraph (c) of this section.

Example (2). Assume the same facts as in example (1) above, except that in addition the wife has a retirement income credit of $160 computed before applying the limitation in section 37 (a). Accordingly, the combined retirement income credit without regard to the limitation in section 37 (a) is the sum of $240 and $160, or $400. The combined retirement income credit allowable on the joint return after applying the limitation in section 37 (a) is $200, computed in exactly the same manner as shown in the example in paragraph (c) of this section.

(e) If retirement income constitutes community income under community property laws applicable to such income, the retirement income credit of each spouse shall be separately computed by taking into account one-half of such amounts. If the husband and wife file a joint return, the limitation in section 37 (a) on the amount of the combined retirement income credit is determined in the manner provided in paragraph (d) of this section. See § 1.37–2 for eligibility requirements that must be met by each spouse.

(f) If the taxpayer elects under section 6014 to have the Government compute his tax, the retirement income credit is not taken into account in such computation.

§ 1.37–2 Eligibility for retirement income credit.

(a) In order to be eligible for the retirement income credit, section 37 (b) provides that the taxpayer must have

received earned income in excess of $600 during each of any 10 calendar years preceding the taxable year. For the purposes of section 37 (b) and section 37 (d) (2), the term "earned income" has the same meaning as in section 911 (b), except that earned income does not include any amount received as a pension or annuity. See section 911 (b) and the regulations thereunder. Section 911 (b) provides, in general, that earned income includes wages, salaries, professional fees, and other amounts received as compensation for personal services rendered. For the purposes of section 37 (b) and section 37 (d) (2), earned income means the entire amount of such income and shall not be reduced by any expenses connected with the earning of such income. Also, for such purposes, income earned by either spouse which constitutes community income under community property laws applicable to such income shall be treated as earned income received one-half by each spouse.

(b) An individual who is a nonresident alien at any time during the taxable year is not eligible for the retirement income credit for such taxable year.

(c) For purposes of determining eligibility, the 10 calendar years must occur before the beginning of the taxable year for which the credit is allowable. If the taxable year is a fiscal year, the calendar year in which such taxable year begins may not be included as one of the 10 calendar years. The 10 calendar years need not immediately precede the taxable year, need not be consecutive, and need not include years subject to the income tax laws. The 10 calendar years may include years for which the taxpayer was exempt from income tax, and may include years for which the taxpayer was not required to file an income tax return or had no income subject to tax, for example, a calendar year during which the individual's income was less than his personal exemption, or a calendar year for which an individual's earned income was excluded from gross income under section 911 (a) or the corresponding provisions of prior revenue laws.

(d) (1) If a husband or wife dies, the earned income which the deceased spouse received in any calendar year shall be treated as earned income of the surviving spouse for such calendar year for the purpose of determining the eligibility of the surviving spouse for the retirement income credit. In any case in which the deceased spouse was eligible for the retirement income credit for the taxable year ending with his death, the surviving spouse will be deemed to have received earned income of more than $600 for 10 calendar years for the purpose of determining the eligibility of the surviving spouse. Thus, in such case, the deceased spouse is allowed a retirement income credit for the retirement income which he received during the taxable year ending with his death, and the surviving spouse is allowed a retirement income credit for the retirement income which she received during her taxable year in which he died, whether joint returns or separate returns are filed. (See, however, paragraph (c) of this section for additional requirement where the taxable year of the surviving spouse is a fiscal year.) If the year of death of the deceased spouse constitutes the tenth year in which he received earned income of more than $600, the deceased spouse is not eligible for the retirement income credit and the surviving spouse will not be deemed to meet the eligibility requirement (solely by virtue of the earned income received by her deceased spouse) for any taxable year prior to her first taxable year beginning in a calendar year subsequent to the calendar year in which he died.

(2) An example of the application of the rule with respect to earned income of a surviving spouse is as follows:

Example. The only earned income of the deceased spouse and the surviving spouse was as follows:

Calendar year	Earned income of deceased spouse	Actual earned income of surviving spouse	Earned income of surviving spouse for purpose of section 37 (b)
(1) 1940	$650		$650
(2) 1942	800		800
(3) 1943	900		900
(4) 1944	650		650
(5) 1946	650		650
(6) 1948	400	$300	700
(7) 1950	600	800	1,400
(8) 1951		800	800
(9) 1952		650	650
(10) 1954		650	650

(e) For the purpose of the rule described in paragraph (d) of this section, it makes no difference when the deceased spouse received the earned income. For example, the surviving spouse is treated as receiving earned income for every year in which the deceased spouse received such income, even though they were not yet married. Furthermore, for purposes of this rule, the earned income received by the deceased spouse during the calendar year in which he died is treated as the earned income of the surviving spouse for such calendar year.

(f) If an individual has married more than once, the status of the individual as a surviving spouse is, for purposes of section 37 (b) and of the rule described in paragraph (d) of this section, determined only by reference to his most recent marriage. An individual is not a surviving spouse of a decedent if they were divorced. If the surviving spouse remarries, he may not determine his eligibility for the retirement income credit for the taxable year in which he remarries or for any subsequent taxable year by treating the earned income of the decedent as his own earned income. If his second spouse dies and the taxpayer does not again remarry, he may apply the rule described in paragraph (d) of this section with respect to his second deceased spouse only. If the second marriage is terminated by divorce rather than by death of the spouse, the taxpayer does not regain the status of being a surviving spouse of the first deceased spouse.

§ 1.37–3 Retirement income.

(a) *Inclusions in retirement income*—(1) *General rule.* Income which may be treated as the retirement income of an individual who is 65 years of age or older at the close of the taxable year is determined under section 37 (c) (1). If the individual has not attained the age of 65 at the close of the taxable year, his retirement income for the taxable year is determined under section 37 (c) (2). See paragraph (b) of this section for the exclusion from retirement income of certain portions of the income described in paragraph (1) or (2) of section 37 (c), whichever is applicable to the individual. See also section 37 (d) and § 1.37–4 for limitations on the amount of retirement income with respect to which the retirement income credit is computed.

(2) *Individuals 65 or over at the close of taxable year.* In the case of individuals who have attained the age of 65 before the close of the taxable year, retirement income consists of income from pensions and annuities, interest, rents, and dividends, to the extent that such income is includible in gross income. Pensions and annuities include (but are not limited to) amounts received as such under a public retirement system or under a retirement system established for members of the Armed Forces of the United States. For the purpose of section 37 (c) (1), income from rents shall be the gross amount received, not reduced by depreciation or other expenses. Retirement income does not include royalties as distinguished from rents.

(3) *Individuals under 65 at close of taxable year.* In the case of individuals who have not attained the age of 65 before the close of the taxable year, retirement income consists only of income received as pensions and annuities from a public retirement system; that is, income from a pension, annuity, retirement, or similar fund or system established by the United States, a State or Territory, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia. However, for taxable years beginning before January 1, 1955, a public retirement system does not include a fund or system established by the United States for members of the Armed Forces of the United States.

(b) *Exclusion from retirement income*—(1) *Compensation for personal services rendered during taxable year.* Retirement income may not include any amount representing compensation for personal services rendered during the taxable year. For this purpose, amounts received as a pension shall not be treated as representing compensation for personal services rendered during the taxable year if the period of service during the taxable year is not substantial when compared with the total years of services. For example, an individual on the calendar year basis retires on November 30 after 5 years of service and receives a pension during the remainder of his taxable year. The pension is not treated as representing compensation for personal services rendered during such taxable year merely because it is paid by reason of the services of the individual for a period of 5 years which includes a portion of the taxable year. In the case of amounts received for board and lodging, the portion of the amount received for board may not be included in retirement income.

(2) *Amounts not includible in gross income.* Retirement income may not include any amount not includible in the gross income of the individual for the taxable year. For example, if a portion of an annuity is excluded from gross income under section 72, relating to annuities, that portion of the annuity is not retirement income; similarly, the portion of dividend income excluded from gross income under section 116, relating to the partial exclusion of dividends received by individuals, is not retirement income.

§ 1.37–4 Limitation on amount of retirement income.

(a) Section 37 (d) provides a limitation on the amount of retirement income with respect to which the retirement income credit is allowable. Such credit is computed on the amount of retirement income, as defined in section 37 (c), but on not more than the amount determined as the limitation provided by section 37(d). In any event, the maximum amount of retirement income with respect to which the retirement income credit is allowable is $1,200.

(b) The limitation provided by section 37 (d) is determined by subtracting from $1,200 the sum of—

(1) Amounts received during the taxable year as (i) a pension or annuity under Title II of the Social Security Act (42 U.S.C. ch. 7); (ii) a pension or annuity under the Railroad Retirement Acts of 1935 or 1937 (45 U.S.C. ch. 9); (iii) any other pension or annuity which is excludable from gross income, such as pensions received under laws relating to veterans; and

(2) (i) For taxable years beginning after December 31, 1955, the amount of earned income received during the taxable year in excess of (*a*) $900, if the individual has not attained the age of 65 before the close of his taxable year, or (*b*) $1,200, if the individual has attained the age of 65 but not 72 before the close of his taxable year; or

(ii) For taxable years beginning before January 1, 1956, the amount of earned income received during the taxable year in excess of $900, if the individual has not attained the age of 75 before the close of his taxable year.

(c) In determining the limitation of section 37 (d), the following additional rules shall be applicable:

(1) No reduction shall be made on account of any amounts excluded from gross income because of the application of section 72 (relating to annuities), section 101 (relating to life insurance proceeds), section 104 (relating to compensation for injuries or sickness), section 105 (relating to amounts received under accident and health plans), section 402 (relating to taxability of beneficiary of employees' trust), or section 403 (relating to taxation of empoyee annuities).

(2) For taxable years beginning after December 31, 1955, no reduction for earned income received during the taxable year shall be made in the case of an individual who has attained the age of 72 before the close of his taxable year; and for taxable years beginning before January 1, 1956, no reduction for earned income received during the taxable year shall be made in the case of an individual who has attained the age of 75 before the close of his taxable year.

(3) The term "earned income" has the same meaning as in paragraph (a) of § 1.37–2. (However, the special rule relating to widows and widowers contained in section 37 (b) is not applicable in determining the limitation of section 37 (d).)

(4) Where the amounts designated in paragraph (b) of this section are treated as community income under community property laws applicable with respect to such income, such amounts shall be treated as received one-half by each spouse.

(5) In no event can the sum of the amounts designated in paragraph (b) of this section reduce the amount of the retirement income, or the credit with respect thereto, to less than zero.

(d) The determination of the limitation of section 37 (d) may be illustrated by the following examples:

Example (1). If an individual eligible for the retirement income credit, age 68 at the close of the taxable year 1954, received as his only income during the taxable year $800 of interest and $1,700 as compensation for personal services rendered by him during such year, the individual is entitled for such taxable year to a retirement income credit on $400 of the interest. Since the individual had not attained the age of 75 before the close of the taxable year, the limitation of section 37 (d) is determined by subtracting from $1,200 the amount of $800, that is, the amount of earned income ($1,700) which is in excess of $900. The limitation is thus $400 ($1,200 less $800) and the retirement income credit is computed on $400 of the retirement income (the interest item). If the individual had attained the age of 75 before the close of the taxable year 1954, no amount would be subtracted from $1,200 by reason of his earned income and the limitation would then be $1,200 instead of $400, and the retirement income credit would be computed on the entire amount of the interest item of $800.

Example (2). Assume that the individual in example (1) received the same items of income for his 1957 taxable year. Since the individual has attained the age of 65 but not the age of 72 before the close of such taxable year, the limitation of section 37 (d) is determined by subtracting from $1,200 the amount of $500, that is, the amount of earned income ($1,700) which is in excess of $1,200. The limitation is thus $700 ($1,200 less $500) and the retirement income credit is computed on $700 of the retirement income (the interest item). If the individual had attained the age of 72 before the close of the taxable year 1957, no amount would be subtracted from $1,200 by reason of his earned income, and the limitation would then be $1,200 instead of $700, and the retirement income credit would be computed on the entire amount of the interest item of $800.

§ 1.37–5 Illustration of application of section 37.

The application of section 37 may be illustrated by the following example:

Example. Assume that an individual eligible for the retirement income credit, 70 years of age, unmarried, computing his tax under section 3, has the following items of income for the calendar year 1956:

Dividend income (of which $50 is excluded from gross income under section 116)	$750
Pension under the Railroad Retirement Act of 1937 (entirely excluded from gross income)	600
Disability payments under a workmen's compensation act (entirely excluded from gross income under section 104)	400
Rental income	600
Earned at odd jobs	1,300

First, the taxpayer must compute his tax before the credit, as follows:

Adjusted gross income ($700 dividend income+$600 rental income +$1,300 earned income)	$2,600
Tax before any credit (determined by table in section 3)	230
Less dividend received credit under section 34	28
Tax before retirement income credit	202

Next, the taxpayer must compute his retirement income credit as follows:

Retirement income includes:	
Dividend income	$700
Rental income	600
Total retirement income	1,300

But the limitations in section 37 (d) provide that this amount may not exceed a maximum amount for the taxable year 1956, determined as follows:

Maximum amount (before reduction)	$1,200
Less railroad retirement pension	600
	600
Less earned income in excess of $1,200	100
Amount of retirement income upon which the credit is computed	500

The retirement income credit is computed by applying the 20-percent rate to the maximum amount of retirement income reduced by the railroad retirement pension and the earned income in excess of $1,200, as follows:

Maximum amount of retirement income as reduced above	$500
20 percent rate	.20
Retirement income credit	100

§ 1.38 Statutory provisions; overpayments of tax.

SEC. 38. *Overpayments of tax.* For credit against the tax imposed by this subtitle for overpayments of tax, see section 6401.

COMPUTATION OF TAXABLE INCOME

DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

§ 1.61 Statutory provisions; gross income defined.

SEC. 61. *Gross income defined*—(a) *General definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;

(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

(b) *Cross references.* For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

§ 1.61–1 Gross income.

(a) *General definition.* Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61–14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

(b) *Cross references.* Cross references to other provisions of the Code are to be found throughout the regulations under section 61. The purpose of these cross references is to direct attention to the more common items which are included in or excluded from gross income entirely, or treated in some special manner. To the extent that another section of the Code or of the regulations thereunder, provides specific treatment for any item of income, such other provision shall apply notwithstanding section 61 and the regulations thereunder. The cross references do not cover all possible items.

(1) For examples of items specifically included in gross income, see part II (section 71 and following), subchapter B, chapter 1 of the Code.

(2) For examples of items specifically excluded from gross income, see part III (section 101 and following), subchapter B, chapter 1 of the Code.

(3) For general rules as to the taxable year for which an item is to be included in gross income, see section 451 and the regulations thereunder.

§ 1.61–2 Compensation for services, including fees, commissions, and similar items.

(a) *In general.* (1) Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. Several special rules apply to members of the Armed Forces, Coast and Geodetic Survey, and Public Health Service of the United States; see paragraph (b) of this section.

(2) The Code provides special rules including the following items in gross income:

(i) Distributions from employees' trusts, see sections 72, 402, and 403, and the regulations thereunder;

(ii) Compensation for child's services (in child's gross income), see section 73 and the regulations thereunder;

(iii) Prizes and awards, see section 74 and the regulations thereunder.

(3) Similarly, the Code provides special rules excluding the following items from gross income in whole or in part:

(i) Gifts, see section 102 and the regulations thereunder;

(ii) Compensation for injuries or sickness, see section 104 and the regulations thereunder;

(iii) Amounts received under accident and health plans, see section 105 and the regulations thereunder;

(iv) Scholarship and fellowship grants, see section 117 and the regulations thereunder;

(v) Miscellaneous items, see section 121.

(b) *Members of the Armed Forces, Coast and Geodetic Survey, and Public Health Service.* Subsistence and uniform allowances granted commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Armed Forces, Coast and Geodetic Survey, and Public Health Service of the United States, and amounts received by them as commutation of quarters, are to be excluded from gross income. Similarly, the value of quarters or subsistence furnished to such persons is to be excluded from gross income. For the exclusion from gross income of—

(1) Disability pensions, see section 104 (a) (4) and the regulations thereunder;

(2) Mustering-out payments, see section 113 and the regulations thereunder;

(3) Miscellaneous items, see section 121.

However, the per diem allowance in lieu of subsistence and the mileage allowance received by such persons while in a travel status or on temporary duty away from their permanent stations shall be included in their gross income.

(c) *Payment to charitable, etc., organization on behalf of person rendering services.* The value of services is not includible in gross income when such services are rendered directly and gratuitously to an organization described in section 170 (c). Where, however, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170 (c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services.

(d) *Compensation paid other than in cash*—(1) *In general.* If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary.

(2) *Property transferred to employee; insurance premiums paid by employer.* Except as otherwise provided in section 421 and the regulations thereunder (relating to employee stock options), if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income. Generally, life insurance premiums paid by an employer on the lives of his employees, where the proceeds of such insurance are payable to the beneficiaries of such employees, are part of the gross income of the employees. However, premiums paid by an employer on policies of group term life insurance covering the lives of his employees are not gross income to the employees, even if they designate the beneficiaries. For special rules relating to the exclusion of contributions by an employer to accident and health plans, see section 106 and the regulations thereunder.

(3) *Meals and living quarters.* The value of living quarters or meals which an employee receives in addition to his salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

(4) *Stock and notes transferred to employee.* If a corporation transfers its own stock to an employee as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

(5) *Property transferred subject to restrictions.* Notwithstanding any other provision of this paragraph, in the case of a transfer by an employer to an employee of any property subject to a restriction which has a significant effect on its value, the rules of § 1.421–6 shall be applied in determining the time and the

amount of compensation to be included in the gross income of the employee. This subparagraph is applicable only to transfers after September 24, 1959.

§ 1.61–3 Gross income derived from business.

(a) *In general.* In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income, and without subtraction of selling expenses, losses, or other items not ordinarily used in computing cost of goods sold. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

(b) *State contracts.* The profit from a contract with a State or political subdivision thereof must be included in gross income. If warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If, upon conversion of the warrants into cash, the contractor does not receive and cannot recover the full value of the warrants so returned, he may deduct any loss sustained from his gross income for the year in which the warrants are so converted. If, however, he realizes more than the value of the warrants so returned, he must include the excess in his gross income for the year in which realized.

§ 1.61–4 Gross income of farmers.

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016 (a) and the regulations thereunder). However, see section 162 and the regulations thereunder with respect to the computation of taxable income on other than the crop method where the cost of seeds or young plants purchased for further development and cultivation prior to sale is involved. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in subparagraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in subparagraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. Crop shares (whether or not considered rent under State law) shall be included in gross income as of the year in which the crop shares are reduced to money or the equivalent of money.

(c) *Special rules for certain receipts.* In the case of the sale of machinery, farm equipment, or any other property (except stock in trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), any excess of the proceeds of the sale over the adjusted basis of such property shall be included in the taxpayer's gross income for the taxable year in which such sale is made. See, however, section 453 and the regulations thereunder for special rules relating to certain installment sales. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Proceeds of insurance, such as hail or fire insurance on growing crops, should be included in gross income to the extent of the amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be computed upon the crop method; but in any such cases, the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized, and not earlier.

(d) *Definition of "farm".* As used in this section, the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. For more detailed rules with respect to the determination of whether or not an individual is engaged in farming, see § 1.175–3. For rules applicable to persons cultivating or operating a farm for recreation or pleasure, see sections 162 and 165, and the regulations thereunder.

(e) *Cross references.* (1) For election to include Commodity Credit Corporation loans as income, see section 77 and regulations thereunder.

(2) For definition of gross income derived from farming for purposes of limiting deductibility of soil and water conservation expenditures, see section 175 and regulations thereunder.

(3) For definition of gross income from farming in connection with declarations of estimated income tax, see section 6073 and regulations thereunder.

§ 1.61–5 Allocations by cooperative associations; tax treatment as to patrons.

(a) *In general.* Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section, regardless of whether the allocation is deemed, for the purpose of section 522, to be made at the close of a

preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services, the cost of which was deductible by the patron under section 162 or section 212, shall be included in the computation of the gross income of such patron, as ordinary income, to the following extent:

(i) If the allocation is in cash, the amount of cash received.

(ii) If the allocation is in merchandise, the amount of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents, the amount of the fair market value of such document at the time of its receipt by the patron. For purposes of this subdivision, any document containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary. However, for purposes of this subdivision, any document which is payable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its receipt by the patron, unless it is clearly established to the contrary.

(iv) If the allocation is in the form of capital stock, the amount of the fair market value, if any, of such capital stock at the time of its receipt by the patron.

(2) If any allocation to which subparagraph (1) of this paragraph applies is received in the form of a document of the type described in subparagraph (1) (iii) or (iv) of this paragraph and is redeemed in full or in part or is otherwise disposed of, there shall be included in the computation of the gross income of the patron, as ordinary income, in the year of redemption or other disposition, the excess of the amount realized on the redemption or other disposition over the amount previously included in the computation of gross income under such subparagraph.

(3) (i) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services, the cost of which was not deductible by the patron under section 162 or section 212, are not includible in the computation of the gross income of such patron. However, in the case of such amounts which are allocated with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, such amounts shall, to the extent set forth in subparagraph (1) of this paragraph, be taken into account by such patron in determining the cost of the property to which the allocation relates. Notwithstanding the preceding sentence, to the extent that such amounts are in excess of the unrecovered cost of such property, and to the extent that such amounts relate to such property which the patron no longer owns, they shall be included in the computation of the gross income of such patron.

(ii) If any patronage dividend is allocated to the patron in the form of a document of the type described in subparagraph (1) (iii) or (iv) of this paragraph, and if such allocation is with respect to capital assets (as defined in section 1221) or property used in the trade or business within the meaning of section 1231, any amount realized on the redemption or other disposition of such document which is in excess of the amount which was taken into account upon the receipt of the document by the patron shall be taken into account by such patron in the year of redemption or other disposition as an adjustment to basis or as an inclusion in the computation of gross income, as the case may be.

(iii) Any adjustment to basis in respect of an amount to which subdivision (i) or (ii) of this subparagraph applies shall be made as of the first day of the taxable year in which such amount is received.

(iv) The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). On July 1, 1959, P, a patron of a cooperative association, purchases a tractor for use in his farming business from such association for $2,200. The tractor has an estimated useful life of five years and an estimated salvage value of $200. P files his income tax returns on a calendar year basis and claims depreciation on the tractor for the year 1959 of $200 pursuant to his use of the straight-line method at the rate of $400 per year. On July 1, 1960, the cooperative association allocates to P with respect to his purchase of the tractor a dividend of $300 in cash. P will reduce his depreciation allowance with respect to the tractor for 1960 (and subsequent taxable years) to $333.33, determined as follows:

Cost of tractor, July 1, 1959		$2,200
Less:		
Depreciation for 1959 (6 mos.)	$200	
Adjustment as of Jan. 1, 1960, for cash patronage dividend	300	
Salvage value	200	
		700
Basis for depreciation for the remaining 4½ years of estimated life		1,500
Basis for depreciation divided by the 4½ years of remaining life		333.33

Example (2). Assume the same facts as in example (1), except that on July 1, 1960, the cooperative association allocates a dividend to P with respect to his purchase of the tractor in the form of a revolving fund certificate having a face amount of $300. The certificate is redeemable in cash at the discretion of the directors of the association and is subject to diminution by any future losses of the association, and has no fair market value when received by P. Since the certificate had no fair market value when received by P, no amount with respect to such certificate was taken into account by him in the year 1960. In 1965, P receives $300 cash from the association in full redemption of the certificate. Prior to 1965, he had recovered through depreciation $2,000 of the cost of the tractor, leaving an unrecovered cost of $200 (the salvage value). For the year 1965, the redemption proceeds of $300 are applied against the unrecovered cost of $200, reducing the basis to zero, and the balance of the redemption proceeds, $100, is includible in the computation of P's gross income.

Example (3). Assume the same facts as in example (2), except that the certificate is redeemed in full on July 1, 1962. The full $300 received on redemption of the certificate will be applied against the unrecovered cost of the tractor as of January 1, 1962, computed as follows:

Cost of tractor, July 1, 1959		$2,200
Less:		
Depreciation for 1959 (6 mos.)	$200	
Depreciation for 1960	400	
Depreciation for 1961	400	
		1,000
Unrecovered cost on Jan. 1, 1962		1,200
Adjustment as of Jan. 1, 1962, for proceeds of the redemption of the revolving fund certificate		300
Unrecovered cost on Jan. 1, 1962, after adjustment		900
Less: Salvage value		200
Basis for depreciation on Jan. 1, 1962		700
If P uses the tractor in his business until June 30, 1964, he would be entitled to the following depreciation allowances with respect to the tractor:		
For 1962	$280	
For 1963	280	
For 1964 (6 mos.)	140	
		700
Balance to be depreciated		0

Example (4). Assume the same facts as in example (3), except that P sells the tractor in 1961. The entire $300 received in 1962 in redemption of the revolving fund certificate is includible in the computation of P's gross income for the year 1962.

(c) *Special rule.* If, for any taxable year ending before December 3, 1959, a taxpayer treated any patronage dividend received in the form of a document described in paragraph (b) (1) (iii) or (iv) of this section in accordance with the regulations then applicable (whether such dividend is subject to paragraph (b) (1) or (3) of this section), such taxpayer is not required to change the treatment of such patronage dividends for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax returns to treat the receipt of such patronage dividend in accordance with the provisions of this section, but no provision in this paragraph shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

§ 1.61–6 Gains derived from dealings in property.

(a) *In general.* Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

Example (1). A, a dealer in real estate, acquires a 10-acre tract for $10,000, which he divides into 20 lots. The $10,000 cost must be equitably apportioned among the lots so that on the sale of each A can determine his taxable gain or deductible loss.

Example (2). B purchases for $25,000 property consisting of a used car lot and adjoining filling station. At the time, the fair market value of the filling station is $15,000 and the fair market value of the used car lot is $10,000. Five years later B sells the filling station for $20,000 at a time when $2,000 has been properly allowed as depreciation thereon. B's gain on this sale is $7,000, since $7,000 is the amount by which the selling price of the filling station exceeds the portion of the cost equitably allocable to the filling station at the time of purchase reduced by the depreciation properly allowed.

(b) *Nontaxable exchanges.* Certain realized gains or losses on the sale or exchange of property are not "recognized", that is, are not included in or deducted from gross income at the time the transaction occurs. Gain or loss from such sales or exchanges is generally recognized at some later time. Examples of such sales or exchanges are the following:

(1) Certain formations, reorganizations, and liquidations of corporations, see sections 331, 333, 337, 351, 354, 355, and 361;

(2) Certain formations and distributions of partnerships, see sections 721 and 731;

(3) Exchange of certain property held for productive use or investment for property of like kind, see section 1031;

(4) A corporation's exchange of its stock for property, see section 1032;

(5) Certain involuntary conversions of property if replaced, see section 1033;

(6) Sale or exchange of residence if replaced, see section 1034;

(7) Certain exchanges of insurance policies and annuity contracts, see section 1035; and

(8) Certain exchanges of stock for stock in the same corporation, see section 1036.

(c) *Character of recognized gain.* Under subchapter P, chapter 1 of the Code, relating to capital gains and losses, certain gains derived from dealings in property are treated specially, and under certain circumstances the maximum rate of tax on such gains is 25 percent, as provided in section 1201. Generally, the property subject to this treatment is a "capital asset", or treated as a "capital asset". For definition of such assets, see sections 1221 and 1231, and the regulations thereunder. For some of the rules either granting or denying this special treatment, see the following sections and the regulations thereunder:

(1) Transactions between partner and partnership, section 707;

(2) Sale or exchange of property used in the trade or business and involuntary conversions, section 1231;

(3) Payment of bonds and other evidences of indebtedness, section 1232;

(4) Gains and losses from short sales, section 1233;

(5) Options to buy or sell, section 1234;

(6) Sale or exchange of patents, section 1235;

(7) Securities sold by dealers in securities, section 1236;

(8) Real property subdivided for sale, section 1237;

(9) Amortization in excess of depreciation, section 1238;

(10) Gain from sale of certain property between spouses or between an individual and a controlled corporation, section 1239;

(11) Taxability to employee of termination payments, section 1240.

§ 1.61–7 Interest.

(a) *In general.* As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of Federal taxes. For rules determining the taxable year in which interest, including interest accrued or constructively received, is included in gross income, see section 451 and the regulations thereunder. For the inclusion of interest in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. For credit of tax withheld at source on interest on tax-free covenant bonds, see section 32 and the regulations thereunder.

(b) *Interest on Government obligations*—(1) *Wholly tax-exempt interest.* Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia, is wholly exempt from tax. Interest on certain United States obligations issued before March 1, 1941, is exempt from tax to the extent provided in the acts of Congress authorizing the various issues. See section 103 and the regulations thereunder.

(2) *Partially tax-exempt interest.* Interest earned on certain United States obligations is partly tax exempt and partly taxable. For example, the interest on United States Treasury bonds issued before March 1, 1941, to the extent that the principal of such bonds exceeds $5,000, is exempt from normal tax but is subject to surtax. See sections 35 and 103, and the regulations thereunder.

(3) *Fully taxable interest.* In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable; but see section 103 and the regulations thereunder. A taxpayer using the cash receipts and disbursements method of accounting who owns United States savings bonds issued at a discount has an election as to when he will report the interest; see section 454 and the regulations thereunder.

(c) *Obligations bought at a discount; bonds bought when interest defaulted or accrued.* When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law. See also paragraph (b) of this section for the rules relating to Government bonds. If a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been paid, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer).

(d) *Bonds sold between interest dates; amounts received in excess of original issue discount; interest on life insurance.* When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income. Amounts received in excess of the original issue discount upon the retirement or sale of a bond or other evidence of indebtedness may under some circumstances constitute capital gain instead of ordinary income. See section 1232 and the regulations thereunder. Interest payments on amounts payable as employees' death benefits (whether or not section 101 (b) applies thereto) and on the proceeds of life insurance policies payable by reason of the insured's death constitute gross income under some circumstances. See section 101 and the regulations thereunder for details. Where accrued interest on unwithdrawn insurance policy dividends is credited annually and is subject to withdrawal annually by the insured, such interest credits constitute taxable income to the insured as of the year of credit.

§ 1.61–8 Rents and royalties.

(a) *In general.* Gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. For the inclusion of rents in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Gross income includes royalties. Royalties may be received from books, stories, plays, copyrights, trademarks, formulas, patents, and from the exploitation of natural resources, such as coal, gas, oil, copper, or timber. Payments received as a result of the transfer of patent rights may under some circumstances constitute capital gain instead of ordinary income. See section 1235 and the regulations thereunder. For special rules for certain income from natural resources, see subchapter I (section 611 and following), chapter 1 of the Code, and the regulations thereunder.

(b) *Advance rentals; cancellation payments.* Gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. An amount received by a lessor from a lessee for cancelling a lease constitutes gross income for the year in which it is received, since it is essentially a substitute for rental payments. As to amounts received by a lessee for the cancellation of a lease, see section 1241 and the regulations thereunder.

(c) *Expenditures by lessee.* As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances. For the exclusion from gross income of income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by a lessee, see section 109 and the regulations thereunder. For the exclusion from gross income of a lessor corporation of certain of its income taxes on rental income paid by a lessee corporation under a lease entered into before January 1, 1954, see section 110 and the regulations thereunder.

§ 1.61–9 Dividends.

(a) *In general.* Except as otherwise specifically provided, dividends are included in gross income under sections 61 and 301. For the principal rules with respect to dividends includible in gross income, see section 316 and the regulations thereunder. As to distributions made or deemed to be made by regulated investment companies, see sections 851 through 855, and the regulations thereunder. See section 116 for the exclusion from gross income of $50 of dividends received by an individual, except those from certain corporations. Furthermore, dividends may give rise to a credit against tax under section 34, relating to dividends received by individuals, and under section 37, relating to retirement income.

(b) *Dividends in kind; stock dividends; stock redemptions.* Gross income includes dividends in property other than cash, as well as cash dividends. For amounts to be included in gross income when distributions of property are made, see section 301 and the regulations thereunder. A distribution of stock, or rights to acquire stock, in the corporation making the distribution is not a dividend except under the circumstances described in section 305 (b). However, the term "dividend" includes a distribution of stock, or rights to acquire stock, in a corporation other than the corporation making the distribution. For determining when distributions in complete liquidation shall be treated as dividends, see section 333 and the regulations thereunder. For rules determining when amounts received in exchanges under section 354 or exchanges and distributions under section 355 shall be treated as dividends, see section 356 and the regulations thereunder.

(c) *Dividends on stock sold.* When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. When stock is sold between the time of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him. The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax. Nor can the purchaser deduct the added amount he advanced to the seller in anticipation of the dividend. That added amount is merely part of the purchase price of the stock. In some cases, however, the purchaser may be considered to be the recipient of the dividend even though he has not received the legal title to the stock itself and does not himself receive the dividend. For example, if the seller retains the legal title to the stock as trustee solely for the purpose of securing the payment of the purchase price, with the understanding that he is to apply the dividends received from time to time in reduction of the purchase price, the dividends are considered to be income to the purchaser.

§ 1.61–10 Alimony and separate maintenance payments; annuities; income from life insurance and endowment contracts.

(a) *In general.* Alimony and separate maintenance payments, annuities, and income from life insurance and endowment contracts in general constitute gross income, unless excluded by law. Annuities paid by religious, charitable, and educational corporations are generally taxable to the same extent as other annuities. An annuity charged upon devised land is taxable to the donee-annuitant to the extent that it becomes payable out of the rents or other income of the land, whether or not it is a charge upon the income of the land.

(b) *Cross references.* For the detailed rules relating to—

(1) Alimony and separate maintenance payments, see section 71 and the regulations thereunder;

(2) Annuities, certain proceeds of endowment and life insurance contracts, see section 72 and the regulations thereunder;

(3) Life insurance proceeds paid by reason of death of insured, employees' death benefits, see section 101 and the regulations thereunder;

(4) Annuities paid by employees' trusts, see section 402 and the regulations thereunder;

(5) Annuities purchased for employee by employer, see section 403 and the regulations thereunder.

§ 1.61–11 Pensions.

(a) *In general.* Pensions and retirement allowances paid either by the Government or by private persons constitute gross income unless excluded by law. Usually, where the taxpayer did not contribute to the cost of a pension and was not taxable on his employer's contributions, the full amount of the pension is to be included in his gross income. But see sections 72, 402, and 403, and the regulations thereunder. When amounts are received from other types of pensions, a portion of the payment may be excluded from gross income. Under some circumstances, amounts distributed from a pension plan in excess of the employee's contributions may constitute long-term capital gain, rather than ordinary income.

(b) *Cross references.* For the inclusion of pensions in income for the purpose of the retirement income credit, see section 37 and the regulations thereunder. Detailed rules concerning the extent to which pensions and retirement allowances are to be included in or excluded from gross income are contained in other sections of the Code and the regulations thereunder. Amounts received as pensions or annuities under the Social Security Act (42 U.S.C. ch. 7) or the Railroad Retirement Act (45 U.S.C. ch. 9) are excluded from gross income. For other partial and total exclusions from gross income, see the following:

(1) Annuities in general, section 72 and the regulations thereunder;

(2) Employees' annuities, sections 402 and 403 and the regulations thereunder;

(3) References to other acts of Congress exempting veterans' pensions and railroad retirement annuities and pensions, section 121.

§ 1.61–12 Income from discharge of indebtedness.

(a) *In general.* The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the

debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

(b) *Proceedings under Bankruptcy Act.* (1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act (11 U. S. C. 32), of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, unless one of the principal purposes of seeking a confirmation under the Bankruptcy Act is the avoidance of income tax, income is not realized by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

(i) A plan of corporate reorganization confirmed under Chapter X of the Bankruptcy Act (11 U. S. C., ch. 10);

(ii) An "arrangement" or a "real property arrangement" confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act (11 U. S. C., ch. 11, 12); or

(iii) A "wage earner's plan" confirmed under Chapter XIII of the Bankruptcy Act (11 U. S. C., ch. 13).

(2) For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness resulting from a proceeding under the Bankruptcy Act, see the regulations under section 1016.

(c) *Sale and purchase by corporation of its bonds.* (1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is income for the taxable year.

(2) If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium, the net amount of such premium is income which should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price, minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income), over the purchase price is income for the taxable year.

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

(4) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the face value of the bonds, the excess of the purchase price over the face value is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the face value, the excess of the face value over the purchase price is income for the taxable year.

(d) *Cross references.* For exclusion from gross income of—

(1) Income from discharge of indebtedness in certain cases, see sections 108 and 1017, and regulations thereunder;

(2) Forgiveness of Government payments to encourage exploration, development, and mining for defense purposes, see section 621 and regulations thereunder.

§ 1.61–13 Distributive share of partnership gross income; income in respect of a decedent; income from an interest in an estate or trust.

(a) *In general.* A partner's distributive share of partnership gross income (under section 702 (c)) constitutes gross income to him. Income in respect of a decedent (under section 691) constitutes gross income to the recipient. Income from an interest in an estate or trust constitutes gross income under the detailed rules of part I (section 641 and following), subchapter J, chapter 1 of the Code. In many cases, these sections also determine who is to include in his gross income the income from an estate or trust.

(b) *Creation of sinking fund by corporation.* If a corporation, for the sole purpose of securing the payment of its bonds or other indebtedness, places property in trust or sets aside certain amounts in a sinking fund under the control of a trustee who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its gross income.

§ 1.61–14 Miscellaneous items of gross income.

(a) *In general.* In addition to the items enumerated in section 61 (a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.

(b) *Cross references.* (1) Prizes and awards, see section 74 and regulations thereunder;

(2) Damages for personal injury or sickness, see section 104 and the regulations thereunder;

(3) Income taxes paid by lessee corporation, see section 110 and regulations thereunder;

(4) Scholarships and fellowship grants, see section 117 and regulations thereunder;

(5) Miscellaneous exemptions under other Acts of Congress, see section 121;

(6) Tax-free covenant bonds, see section 1451 and regulations thereunder.

§ 1.62 Statutory provisions; adjusted gross income defined.

SEC. 62. *Adjusted gross income defined.* For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) *Trade and business deductions.* The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) *Trade and business deductions of employees*—(A) *Reimbursed expenses.* The deductions allowed by part VI (sec. 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.

(B) *Expenses for travel away from home.* The deductions allowed by part VI (sec. 161 and following) which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(C) *Transportation expenses.* The deductions allowed by part VI (sec. 161 and following) which consist of expenses of transportation paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(D) *Outside salesmen.* The deductions allowed by part VI (sec. 161 and following) which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer.

(3) *Long-term capital gains.* The deduction allowed by section 1202.

(4) *Losses from sale or exchange of property.* The deductions allowed by part VI (sec. 161 and following) as losses from the sale or exchange of property.

(5) *Deductions attributable to rents and royalties.* The deductions allowed by part VI (sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.

(6) *Certain deductions of life tenants and income beneficiaries of property.* In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by section 167 and the deduction allowed by section 611. Nothing in this section shall permit the same item to be deducted more than once.

§ 1.62–1 Adjusted gross income.

(a) The term "adjusted gross income" means the gross income computed under section 61 minus such of the deductions allowed by chapter 1 of the Code as are specified in section 62. Adjusted gross income is used as the basis for the determination of the following:

(1) The optional tax if adjusted gross income is less than $5,000 (under section 3);

(2) The amount of the standard deduction (under section 141);

(3) The limitation on the amount of the deduction for charitable contributions (under section 170 (b) (1));

(4) The limitation on the amount of the deduction for medical and dental expenses (under section 213); and

(5) In certain cases, the limitation on the deduction for expenses of care of certain dependents (under section 214).

(b) Section 62 merely specifies which of the deductions provided in chapter 1 of the Code shall be allowed in computing adjusted gross income. It does not create any new deductions. The fact that a particular item may be specified in more than one of the paragraphs under section 62 does not permit the item to be twice deducted in computing either adjusted gross income or taxable income.

(c) The deductions specified in section 62 for the purpose of computing adjusted gross income are:

(1) Deductions allowable under chapter 1 of the Code (other than by Part VII (section 211 and following), subchapter B of such chapter) which are attributable to a trade or business carried on by the taxpayer not consisting of services performed as an employee;

(2) Deductions allowable under part VI (section 161 and following), subchapter B, chapter 1 of the Code, which consist of expenses paid or incurred in connection with the performance of services by the taxpayer as an employee under a reimbursement or other expense-allowance arrangement with his employer;

(3) Deductions allowable under part VI which constitute expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee;

(4) Transportation expenses (as defined in paragraph (g) of this section) paid or incurred by the taxpayer in connection with the performance by him of services as an employee, allowable as a deduction under part VI;

(5) Deductions allowable by part VI which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer;

(6) The deduction for long-term capital gains allowed by section 1202;

(7) Deductions which are allowable under part VI as losses from the sale or exchange of property;

(8) Deductions allowable under part VI, section 212, and section 611 which are attributable to property held for the production of rents or royalties; and

(9) Deductions for depreciation and depletion allowable under sections 167 and 611 to a life tenant of property or to an income beneficiary of property held in trust or to an heir, legatee, or devisee of an estate.

(d) For the purpose of the deductions specified in section 62, the performance of personal services as an employee does not constitute the carrying on of a trade or business, except as otherwise expressly provided. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section. To be deductible for the purposes of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible, but State taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

(e) Traveling expenses paid or incurred by an employee in connection with his employment while away from home which are deductible from gross income under part VI in computing taxable income may be deducted from gross income in computing adjusted gross income. Among the items included in traveling expenses are charges for transportation of persons or baggage, expenditures for meals and lodging, and payments for the use of sample rooms for the display of goods. See section 162 and the regulations thereunder.

(f) (1) Expenses paid or incurred by an employee which are deductible from gross income under part VI in computing taxable income and for which he is reimbursed by the employer under an express agreement for reimbursement or pursuant to an expense allowance arrangement may be deducted from gross income in computing adjusted gross income. Where an employee is reimbursed by his employer in an amount less than his total expense, and the reimbursement is intended to cover all types of deductible expenses, expenses other than those described in section 62 (2) (B), (C), and (D) are taken into account in computing adjusted gross income in an amount which bears the same ratio to the amount of the reimbursement as the total amount of deductible expenses computed without those described in section 62 (2) (B), (C), and (D) bears to the total amount of deductible expenses, including those described in section 62 (2) (B), (C), and (D).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: S, who is not a full-time outside salesman, received a salary of $20,000 and an expense allowance of $1,200 for the calendar year 1954. He expended $800 for travel, meals, and lodging while away from home, $500 for local transportation expenses and $300 for the entertainment of customers. His adjusted gross income is computed as follows:

Salary	$20,000	
Expense allowance	1,200	
Gross income		$21,200
Less:		
Travel, meals and lodging while away from home	$800	
Transportation expense	500	
Reimbursed expenses [1]	225	
		1,525
Adjusted gross income		$19,675

[1] The amount of the reimbursement allocable to entertainment expenses is determined as follows:

Travel, meals, and lodging while away from home	$800
Transportation expense	500
Expenses deductible in arriving at adjusted gross income (whether or not reimbursed)	1,300
Entertainment expense	300
Total expenses	1,600
Deductible for adjusted gross income: 300/1,600 × $1,200 (expense allowance)	225

(g) Transportation expenses paid or incurred by an employee in connection with performance by him of services for his employer are deductible from gross income under part VI in computing adjusted gross income. "Transportation", as used in section 62 (2) (C), is a narrower concept than "travel", as used in section 62 (2) (B), and does not include meals and lodging. The term "transportation expense" includes only the cost of transporting the employee from one

place to another in the course of his employment, while he is not away from home in a travel status. Thus, transportation costs may include cab fares, bus fares, and the like, and also a pro rata share of the employee's expenses of operating his automobile, including gas, oil, and depreciation. All transportation expenses must be allowable expenses under part VI (section 161 and following), subchapter B, chapter 1 of the Code, as ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business as an employee. Transportation expenses do not include the cost of commuting to and from work; this cost constitutes a personal, living, or family expense and is not deductible. (See section 262.)

(h) The expenses of an employee attributable to the trade or business carried on as an outside salesman which are allowed by part VI are deductible from gross income in computing adjusted gross income. An outside salesman is an individual who solicits business as a full-time salesman for his employer away from his employer's place of business. The term "outside salesman" does not include a taxpayer whose principal activities consist of service and delivery. For example, a bread driver-salesman or a milk driver-salesman would not be included within the definition. However, an outside salesman may perform incidental inside activities at his employer's place of business, such as writing up and transmitting orders and spending short periods at the employer's place of business to make and receive telephone calls, without losing his classification as an outside salesman.

§ 1.63 Statutory provisions; taxable income defined.

SEC. 63. *Taxable income defined*—(a) *General rule.* Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

(b) *Individuals electing standard deduction.* In the case of an individual electing under section 144 to use the standard deduction provided in part IV (sec. 141 and following), for purposes of this subtitle the term "taxable income" means adjusted gross income, minus—

(1) Such standard deduction, and

(2) The deductions for personal exemptions provided in section 151.

ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

§ 1.71 Statutory provisions; alimony and separate maintenance payments.

SEC. 71. *Alimony and separate maintenance payments*—(a) *General rule*—(1) *Decree of divorce or separate maintenance.* If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

(2) *Written separation agreement.* If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). This paragraph shall not apply if the husband and wife make a single return jointly.

(3) *Decree for support.* If a wife is separated from her husband, the wife's gross income includes periodic payments (whether or not made at regular intervals) received by her after the date of the enactment of this title from her husband under a decree entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. This paragraph shall not apply if the husband and wife make a single return jointly.

(b) *Payments to support minor children.* Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

(c) *Principal sum paid in installments*—(1) *General rule.* For purposes of subsection (a), installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument, or agreement shall not be treated as periodic payments.

(2) *Where period for payment is more than 10 years.* If, by the terms of the decree, instrument, or agreement, the principal sum referred to in paragraph (1) is to be paid or may be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement, then (notwithstanding paragraph (1)) the installment payments shall be treated as periodic payments for purposes of subsection (a), but (in the case of any one taxable year of the wife) only to the extent of 10 percent of the principal sum. For purposes of the preceding sentence, the part of any principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be treated as an installment payment for the taxable year in which it is received.

(d) *Rule for husband in case of transferred property.* The husband's gross income does not include amounts received which, under subsection (a), are (1) includible in the gross income of the wife, and (2) attributable to transferred property.

(e) *Cross references.* (1) For definitions of "husband" and "wife", see section 7701 (a) (17).

(2) For deduction by husband of periodic payments not attributable to transferred property, see section 215.

(3) For taxable status of income of an estate or trust in case of divorce, etc., see section 682.

§ 1.71–1 Alimony and separate maintenance payments; income to wife or former wife.

(a) *In general.* Section 71 provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or separated. For convenience, the payee spouse will hereafter in this section be referred to as the "wife" and the spouse from whom she is divorced or separated as the "husband." See section 7701 (a) (17). For rules relative to the deduction by the husband of periodic payments not attributable to transferred property, see section 215 and the regulations thereunder. For rules relative to the taxable status of income of an estate or trust in case of divorce, etc., see section 682 and the regulations thereunder.

(b) *Alimony or separate maintenance payments received from the husband*—(1) *Decree of divorce or separate maintenance.* (i) In the case of divorce or legal separation, paragraph (1) of section 71 (a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after a decree of divorce or of separate maintenance. Such periodic payments must be made in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a court order or decree divorcing or legally separating the husband and wife or a written instrument incident to the divorce status or legal separation status.

(ii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(2) *Written separation agreement.* (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71 (a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her pursuant to a written separation agreement executed after August 16, 1954. The periodic payments must be made under the terms of the written separation agreement after its execution and because of the marital or family relationship. Such payments are includible in the wife's gross income whether or not the agreement is a legally enforceable instrument. Moreover, if the wife is divorced or legally separated subsequent to the written separation agreement, payments made under such agreement continue to fall within the provisions of section 71 (a) (2).

(ii) For purposes of section 71 (a) (2), any written separation agreement executed on or before August 16, 1954, which is altered or modified in writing by the parties in any material respect after that date will be treated as an agreement executed after August 16, 1954, with respect to payments made after the date of alteration or modification.

(iii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(3) *Decree for support.* (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (3) of section 71 (a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after August 16, 1954, from her husband under any type of court order or decree (including an interlocutory de-

cree of divorce or a decree of alimony pendente lite) entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. It is not necessary for the wife to be legally separated or divorced from her husband under a court order or decree; nor is it necessary for the order or decree for support to be for the purpose of enforcing a written separation agreement.

(ii) For purposes of section 71 (a) (3), any decree which is altered or modified by a court order entered after March 1, 1954, will be treated as a decree entered after such date.

(4) *Scope of section 71 (a).* Section 71 (a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement. Thus, section 71 (a) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife.

(5) *Year of inclusion.* Periodic payments are includible in the wife's income under section 71 (a) only for the taxable year in which received by her. As to such amounts, the wife is to be treated as if she makes her income tax returns on the cash receipts and disbursements method, regardless of whether she normally makes such returns on the accrual method. However, if the periodic payments described in section 71 (a) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 652, 662, and 682, whether or not such payments are made out of the income of such estates or trusts.

(6) *Examples.* The foregoing rules are illustrated by the following examples in which it is assumed that the husband and wife file separate income tax returns on the calendar year basis:

Example (1). W files suit for divorce from H in 1953. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H agrees in writing to pay $200 a month to W during her lifetime if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce entered December 31, 1953. During 1954, H pays W $200 a month, pursuant to the promise. The $2,400 thus received by W is includible in her gross income under the provisions of section 71 (a) (1). Under section 215, H is entitled to a deduction of $2,400 from his gross income.

Example (2). During 1945, H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household expenses, H promises to pay W $200 a month during her lifetime. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 71 (a) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce status, section 71 (a) (1) would require the inclusion in W's gross income of the payments received by her after the decree. Similarly, if a written separation agreement were executed after August 16, 1954, and incorporated the payment provisions of the antenuptial agreement, section 71 (a) (2) would require the inclusion in W's income of payments received by W after W begins living apart from H, whether or not the divorce decree was subsequently entered and whether or not W was living apart from H when the separation agreement was executed, provided that such payments were made after such agreement was executed and pursuant to its terms. As to including such payments in W's income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, or created pursuant to the written separation agreement, see section 682 and the regulations thereunder.

Example (3). H and W are separated and living apart during 1954. W sues H for support and on February 1, 1954, the court enters a decree requiring H to pay $200 a month to W for her support and maintenance. No part of the $200 a month support payments is includible in W's income under section 71 (a) (3) or deductible by H under section 215. If, however, the decree had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, the payments received by W after August 16, 1954, under the decree as altered or modified would be includible in her income under section 71 (a) (3) and deductible by H under section 215.

Example (4). W sues H for divorce in 1954. On January 15, 1954, the court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1954, the court grants W a divorce and awards her $200 a month permanent alimony. No part of the $25 a week temporary alimony received prior to the decree is includible in W's income under section 71 (a), but the $200 a month received during the remainder of 1954 by W is includible in her income for 1954. Under section 215, H is entitled to deduct such $200 payments from his income. If, however, the decree awarding W temporary alimony had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, temporary alimony received by her after August 16, 1954, would be includible in her income under section 71 (a) (3) and deductible by H under section 215.

(c) *Alimony and separate maintenance payments attributable to property.* (1) (i) In the case of divorce or legal separation, paragraph (1) of section 71 (a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) attributable to property transferred, in trust or otherwise, and received by her after a decree of divorce or of separate maintenance. Such property must have been transferred in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a decree of divorce or separate maintenance or under a written instrument incident to such divorce status or legal separation status.

(ii) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71 (a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her which are attributable to property transferred, in trust or otherwise, under a written separation agreement executed after August 16, 1954. The property must be transferred because of the marital or family relationship. The periodic payments attributable to the property must be received by the wife after the written separation agreement is executed.

(iii) The periodic payments received by the wife attributable to property transferred under subdivisions (i) and (ii) of this subparagraph and includible in her gross income are not to be included in the gross income of the husband.

(2) The full amount of periodic payments received under the circumstances described in section 71 (a) (1), (2), and (3) is required to be included in the gross income of the wife regardless of the source of such payments. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the husband from his income or capital. For example, if in order to meet an alimony or separate maintenance obligation of $500 a month the husband purchases or assigns for the benefit of his wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 72 (k) and the regulations thereunder. Likewise, if property is transferred by the husband, subject to an annual charge of $5,000, payable to his wife in discharge of his alimony or separate maintenance obligation under the divorce or separation decree or written instrument incident to the divorce status or legal separation status or if such property is transferred pursuant to a written separation agreement and subject to a similar annual charge, the $5,000 received annually is, under section 71 (a) (1) or (2), includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(3) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which section 71 (a) (1) and (2) applies is includible in the wife's income regardless of whether such payments are made out of trust income. Such periodic payments are to be included in the wife's income under section 71 (a) (1) or (2) and are to be excluded from the husband's income even though the income of the trust would otherwise be includible in his income under subpart E, part I, subchapter J, chapter 1 of the Code, relating to trust income attributable to grantors and others as substantial owners. As to periodic payments received by a wife attributable to property in trust in cases to which section 71 (a) (1) or (2) does not apply because the husband's obligation is not specified in the decree or an instrument

incident to the divorce status or legal separation status or the property was not transferred under a written separation agreement, see section 682 and the regulations thereunder.

(4) Section 71 (a) (1) or (2) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident to the divorce status or legal separation status, or transferred pursuant to the written separation agreement, which interest originally belonged to the wife. It will apply, however, if she received such interest from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfer securities, which were owned by them jointly, in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife attributable to the husband's interest in the securities transferred in discharge of his obligation under the decree, or instrument incident to the divorce status or legal separation status, or transferred under the written separation agreement, is taxable to her under section 71 (a) (1) or (2), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income as provided in part I (sections 641 and following), subchapter J, chapter 1 of the Code. If, however, the husband's transfer to his wife is made before such property is transferred in discharge of his obligation under the decree or written instrument, or pursuant to the separation agreement in an attempt to avoid the application of section 71 (a) (1) or (2) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation or pursuant to such agreement. In such a case, section 71 (a) (1) or (2) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see section 72 and the regulations thereunder.

(d) *Periodic and installment payments.* (1) In general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement are not considered "periodic payments" and therefore are not to be included under section 71 (a) in the wife's income.

(2) An exception to the general rule stated in subparagraph (1) of this paragraph is provided, however, in cases where such principal sum, by the terms of the decree, instrument, or agreement, may be or is to be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement. In such cases, the installment payment is considered a periodic payment for the purposes of section 71 (a) but only to the extent that the installment payment, or sum of the installment payments, received during the wife's taxable year does not exceed 10 percent of the principal sum. This 10-percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.

(3) (i) Where payments under a decree, instrument, or agreement are to be paid over a period ending 10 years or less from the date of such decree, instrument, or agreement, such payments are not installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement (and are considered periodic payments for the purposes of section 71 (a)) only if such payments meet the following two conditions:

(*a*) Such payments are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse, and

(*b*) Such payments are in the nature of alimony or an allowance for support.

(ii) Payments meeting the requirements of subdivision (i) are considered periodic payments for the purposes of section 71 (a) regardless of whether—

(*a*) The contingencies described in subdivision (i) (*a*) of this subparagraph are set forth in the terms of the decree, instrument, or agreement, or are imposed by local law, or

(*b*) The aggregate amount of the payments to be made in the absence of the occurrence of the contingencies described in subdivision (i) (*a*) of this subparagraph is explicitly stated in the decree, instrument, or agreement or may be calculated from the face of the decree, instrument, or agreement, or

(*c*) The total amount which will be paid may be calculated actuarially.

(4) Where payments under a decree, instrument, or agreement are to be paid over a period ending more than ten years from the date of such decree, instrument, or agreement, but where such payments meet the conditions set forth in subparagraph (3) (i) of this paragraph, such payments are considered to be periodic payments for the purpose of section 71 without regard to the rule set forth in subparagraph (2) of this paragraph. Accordingly, the rules set forth in subparagraph (2) of this paragraph are not applicable to such payments.

(5) The rules as to periodic and installment payments are illustrated by the following examples:

Example (1). Under the terms of a written instrument, H is required to make payments to W which are in the nature of alimony, in the amount of $100 a month for nine years. The instrument provides that if H or W dies the payments are to cease. The payments are periodic.

Example (2). The facts are the same as in example (1) except that the written instrument explicitly provides that H is to pay W the sum of $10,800 in monthly payments of $100 over a period of nine years. The payments are periodic.

Example (3). Under the terms of a written instrument, H is to pay W $100 a month over a period of nine years. The monthly payments are not subject to any of the contingencies of death of H or W, remarriage of W, or change in the economic status of H or W under the terms of the written instrument or by reason of local law. The payments are not periodic.

Example (4). A divorce decree in 1954 provides that H is to pay W $20,000 each year for the next five years, beginning with the date of the decree, and then $5,000 each year for the next ten years. Assuming the wife makes her returns on the calendar year basis, each payment received in the years 1954 to 1958, inclusive, is treated as a periodic payment under section 71 (a) (1), but only to the extent of 10 percent of the principal sum of $150,000. Thus, for such taxable years, only $15,000 of the $20,000 received is includible under section 71 (a) (1) in the wife's income and is deductible by the husband under section 215. For the years 1959 to 1968, inclusive, the full $5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

(e) *Payments for support of minor children.* Section 71 (a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71 (a), is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree, instrument, or agreement required to pay $200 a month to his divorced wife, $100 of which is designated by the decree, instrument, or agreement to be for the support of their minor children, and the husband pays only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 71 (a). Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in section 71 (a) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.

§ 1.71–2 Effective date; taxable years ending after March 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a) (1) (C), the regulations prescribed in § 1.71–1, to the extent that they relate to payments under a written separation agreement executed after August 16, 1954, and to the extent that they relate to payments under a decree for support received after August 16, 1954, under a decree entered

after March 1, 1954, shall also apply to taxable years beginning before January 1, 1954, and ending after August 16, 1954, although such years are subject to the Internal Revenue Code of 1939.

§ 1.72 Statutory provisions; annuities; certain proceeds of endowment and life insurance contracts.

SEC. 72. *Annuities; certain proceeds of endowment and life insurance contracts*—(a) *General rule for annuities.* Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

(b) *Exclusion ratio.* Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). This subsection shall not apply to any amount to which subsection (d) (1) (relating to certain employee annuities) applies.

(c) *Definitions*—(1) *Investment in the contract.* For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A) The aggregate amount of premiums or other consideration paid for the contract, minus

(B) The aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(2) *Adjustment in investment where there is refund feature.* If—

(A) The expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

(B) The contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant or annuitants; and

(C) Such payments are in the nature of a refund of the consideration paid,

then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary or his delegate. For purposes of this paragraph and of subsection (e) (2) (A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1) (A).

(3) *Expected return.* For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) *Life expectancy.* If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary or his delegate.

(B) *Installment payments.* If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

(4) *Annuity starting date.* For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract; except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

(d) *Employees' annuities*—(1) *Employee's contributions recoverable in 3 years.* Where—

(A) Part of the consideration for an annuity, endowment, or life insurance contract is contributed by the employer, and

(B) During the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received under the contract as an annuity, the aggregate amount receivable by the employee under the terms of the contract is equal to or greater than the consideration for the contract contributed by the employee,

then all amounts received as an annuity under the contract shall be excluded from gross income until there has been so excluded (under this paragraph and prior income tax laws) an amount equal to the consideration for the contract contributed by the employee. Thereafter all amounts so received under the contract shall be included in gross income.

(2) *Special rules for application of paragraph (1).* For purposes of paragraph (1), if the employee died before any amount was received as an annuity under the contract, the words "receivable by the employee" shall be read as "receivable by a beneficiary of the employee".

(3) *Cross reference.* For certain rules for determining whether amounts contributed by employer are includible in the gross income of the employee, see part I of subchapter D (sec. 401 and following, relating to pension, profit-sharing, and stock bonus plans, etc.).

(e) *Amounts not received as annuities*—(1) *General rule.* If any amount is received under an annuity, endowment, or life insurance contract, if such amount is not received as an annuity, and if no other provision of this subtitle applies, then such amount—

(A) If received on or after the annuity starting date, shall be included in gross income; or

(B) If subparagraph (A) does not apply, shall be included in gross income, but only to the extent that it (when added to amounts previously received under the contract which were excludable from gross income under this subtitle or prior income tax laws) exceeds the aggregate premiums or other consideration paid.

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) *Special rules for application of paragraph (1).* For purposes of paragraph (1), the following shall be treated as amounts not received as an annuity:

(A) Any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract; and

(B) Any amount received under a contract on its surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (1) (B) shall apply (and the rule of paragraph (1) (A) shall not apply).

(3) *Limit on tax attributable to receipt of lump sum.* If a lump sum is received under an annuity, endowment, or life insurance contract, and the part which is includible in gross income is determined under paragraph (1), then the tax attributable to the inclusion of such part in gross income for the taxable year shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of the taxpayer ratably over the taxable year in which received and the preceding 2 taxable years.

(f) *Special rules for computing employees' contributions.* In computing, for purposes of subsection (c) (1) (A), the aggregate amount of premiums or other consideration paid for the contract, for purposes of subsection (d) (1), the consideration for the contract contributed by the employee, and for purposes of subsection (e) (1) (B), the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that—

(1) Such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws; or

(2) If such amounts had been paid directly to the employee at the time they were contributed, they would not have been includible in the gross income of the employee under the law applicable at the time of such contribution.

(g) *Rules for transferee where transfer was for value.* Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1) For purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) For purposes of subsection (c) (1) (B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) The annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

(h) *Option to receive annuity in lieu of lump sum.* If—

(1) A contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;

(2) The option is exercised within 60 days after the day on which such lump sum first became payable; and

(3) Part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e) (1), then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.

(i) *Joint and survivor annuities where first annuitant died in 1951, 1952, or 1953.* Where an annuitant died after December 31, 1950, and before January 1, 1954, and the basis of a surviving annuitant's interest in the joint and survivor annuity contract was determinable under section 113 (a) (5) of the Internal Revenue Code of 1939, then—

(1) Subsection (d) shall not apply with respect to such contract;

(2) For purposes of this section, the aggregate amount of premiums or other consideration paid for the contract is the basis of the contract determined under such section 113 (a) (5);

(3) For purposes of subsection (c) (1) (B), there shall be taken into account only the aggregate amount received by the sur-

viving annuitant under the contract before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(4) The annuity starting date is January 1, 1954, or the first day of the first period for which the surviving annuitant received an amount under the contract as an annuity, whichever is the later.

(j) *Interest.* Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon the interest payments shall be included in gross income.

(k) *Payments in discharge of alimony—*(1) *In general.* This section shall not apply to so much of any payment under an annuity, endowment, or life insurance contract (or any interest therein) as is includible in the gross income of the wife under section 71 or section 682 (relating to income of an estate or trust in case of divorce, etc.).

(2) *Cross reference.* For definition of "wife", see section 7701 (a) (17).

(l) *Face-amount certificates.* For purposes of this section, the term "endowment contract" includes a face-amount certificate, as defined in section 2 (a) (15) of the Investment Company Act of 1940 (15 U. S. C., sec. 80a–2), issued after December 31, 1954.

(m) *Cross reference.* For limitation on adjustments to basis of annuity contracts sold, see section 1021.

§ 1.72–1 Introduction.

(a) *General principle.* Section 72 prescribes rules relating to the inclusion in gross income of amounts received under a life insurance, endowment, or annuity contract unless such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code. In general, these rules provide that amounts subject to the provisions of section 72 are includible in the gross income of the recipient except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid.

(b) *Amounts to be considered as a return of premiums.* For the purpose of determining the extent to which amounts received represent a reduction or return of premiums or other consideration paid, the provisions of section 72 distinguish between "amounts received as an annuity" and "amounts not received as an annuity". In general, "amounts received as an annuity" are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date. See paragraph (b) (2) and (3) of § 1.72–2. Any other amounts to which the provisions of section 72 apply are considered to be "amounts not received as an annuity". See § 1.72–11.

(c) *"Amounts received as an annuity."* (1) In the case of "amounts received as an annuity" (other than certain employees' annuities described in section 72 (d) and in § 1.72–13), a proportionate part of each amount so received is considered to represent a return of premiums or other consideration paid. The proportionate part of each annuity payment which is thus excludable from gross income is determined by the ratio which the investment in the contract as of the date on which the annuity is deemed to begin bears to the expected return under the contract as of that date. See § 1.72–4.

(2) In the case of employees' annuities of the type described in section 72 (d), no amount received as an annuity in a taxable year to which the Internal Revenue Code of 1954 applies is includible in the gross income of a recipient until the aggregate of all amounts received thereunder and excluded from gross income under the applicable income tax law exceeds the consideration contributed (or deemed contributed) by the employee under § 1.72–8. Thereafter, all amounts so received are includible in the gross income of the recipient. See § 1.72–13.

(d) *"Amounts not received as an annuity."* In the case of "amounts not received as an annuity", if such amounts are received after an annuity has begun and during its continuance, amounts so received are generally includible in the gross income of the recipient. Amounts not received as an annuity which are received at any other time are includible in the gross income of the recipient only to the extent that such amounts, when added to all amounts previously received under the contract which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt, exceed the premiums or other consideration paid. See § 1.72–11.

(e) *Classification of recipients.* For the purpose of the regulations under section 72, a recipient shall be considered an "annuitant" if he receives amounts under an annuity contract during the period that the annuity payments are to continue, whether for a term certain or during the continuing life or lives of the person or persons whose lives measure the duration of such annuity. However, a recipient shall be considered a "beneficiary" rather than an "annuitant" if the amounts he receives under a contract are received after the term of the annuity for a life or lives has expired and such amounts are paid by reason of the fact that the contract guarantees that payments of some minimum amount or for some minimum period shall be made. For special rules with respect to beneficiaries, see paragraphs (a) (1) (iii) and (c) of § 1.72–11.

§ 1.72–2 Applicability of section.

(a) *Contracts.* (1) The contracts under which amounts paid will be subject to the provisions of section 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For the purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company. The term "endowment contract" also includes the "face-amount certificates" described in section 72 (1). In addition, sections 402 and 403 provide that certain employees' trust and plan distributions are subject to the provisions of section 72, except section 72 (e) (3). In such cases the regulations under section 72 shall be applied to all the distributions with respect to a particular employee under each such trust or plan as though such payments were provided under a single contract to which section 72 applied. As used hereafter in these regulations, therefore, the term "contract" shall be considered to include the entire interest of an employee in each trust or plan described in sections 402 and 403 to the extent that distributions thereunder are subject to the provisions of section 72.

(2) If two or more annuity obligations or elements to which section 72 applies are acquired for a single consideration, such as an obligation to pay an annuity to A for his life accompanied by an obligation to pay an annuity to B for his life, there being a single consideration paid for both obligations (whether paid by one or more persons in equal or different amounts, and whether paid in a single sum or otherwise), such annuity elements shall be considered to comprise a single contract for the purpose of the application of section 72 and the regulations thereunder. For rules relating to the allocation of investment in the contract in the case of annuity elements payable to two or more persons, see paragraph (b) of § 1.72–6.

(b) *Amounts.* (1) (i) In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a) (1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

(ii) Section 72 does not exclude from gross income any amounts received under an agreement to hold an amount and pay interest thereon. See paragraph (a) of § 1.72–14. However, section 72 does apply to amounts received by a surviving annuitant under a joint and survivor annuity contract since such amounts are not considered to be paid by reason of the death of an insured. For a special deduction for the estate tax attributable to the inclusion of the value of the interest of a surviving annuitant under a joint and survivor annuity contract in the estate of the deceased primary annuitant, see section 691 (d) and the regulations thereunder.

(2) Amounts subject to section 72 in accordance with subparagraph (1) of this paragraph are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) They must be received on or after the "annuity starting date" as that term is defined in paragraph (b) of § 1.72–4;

(ii) They must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date; and

(iii) Except as indicated in subparagraph (3) of this paragraph, the total of

the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

For the purpose of determining whether amounts subject to section 72 (d) and § 1.72–13 are "amounts received as an annuity", however, the provisions of subdivision (i) of this subparagraph shall be disregarded. In addition, the term "amounts received as an annuity" does not include amounts received to which the provisions of paragraph (b) or (c) of § 1.72–11 apply, relating to dividends and certain amounts received by a beneficiary in the nature of a refund. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, the requirements of subdivision (iii) of this subparagraph are met with respect to the payments determinable at the outset by means of computations involving the fixed interest rate, but any payments received after the expiration of the period determinable by such computations shall be taxable as dividends received after the annuity starting date in accordance with paragraph (b) (2) of § 1.72–11.

(3) (i) Notwithstanding the requirement of subparagraph (2) (iii) of this paragraph, if amounts are to be received for a definite or determinable time (whether for a period certain or for a life or lives) under a contract which provides:

(*a*) That the amount of the periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans), cost of living indices, or similar fluctuating criteria, or

(*b*) For specified payments the value of which may vary for income tax purposes, such as in the case of any annuity payable in foreign currency,

each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time that the periodic payments are to be made. If payments are to be made more frequently than annually, the amount so computed shall be multiplied by the number of periodic payments to be made during the taxable year for the purpose of determining the total amount which may be considered received as an annuity during such year. To this extent, the payments received shall be considered to represent a return of premium or other consideration paid and shall be excludable from gross income in the taxable year in which received. See paragraph (d) (2) and (3) of § 1.72–4. To the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient. See section 72 (e) and paragraph (b) (2) of § 1.72–11.

(ii) For purposes of subdivision (i) of this subparagraph, the number of periodic payments anticipated during the time payments are to be made shall be determined by multiplying the number of payments to be made each year (*a*) by the number of years payments are to be made, or (*b*) if payments are to be made for a life or lives, by the multiple found by the use of the appropriate tables contained in § 1.72–9, as adjusted in accordance with the table in paragraph (a) (2) of § 1.72–5.

(iii) For an example of the computation to be made in accordance with this subparagraph and a special election which may be made in a taxable year subsequent to a taxable year in which the total payments received under a contract described in this subparagraph are less than the total of the amounts excludable from gross income in such year under subdivision (i) of this subparagraph, see paragraph (d) (3) of § 1.72–4.

§ 1.72–3 Excludable amounts not income.

In general, amounts received under contracts described in paragraph (a) (1) of § 1.72–2 are not to be included in the income of the recipient to the extent that such amounts are excludable from gross income as the result of the application of section 72 and the regulations thereunder.

§ 1.72–4 Exclusion ratio.

(a) *General rule.* (1) (i) To determine the proportionate part of the total amount received each year as an annuity which is excludable from the gross income of a recipient in the taxable year of receipt (other than amounts received under certain employee annuities described in section 72(d) and § 1.72–13), an exclusion ratio is to be determined for each contract. In general, this ratio is determined by dividing the investment in the contract as found under § 1.72–6 by the expected return under such contract as found under § 1.72–5. Where a single consideration is given for a particular contract which provides for two or more annuity elements, an exclusion ratio shall be determined for the contract as a whole by dividing the investment in such contract by the aggregate of the expected returns under all the annuity elements provided thereunder. However, where the provisions of paragraph (b) (3) of § 1.72–2 apply to payments received under such a contract, see paragraph (b) (3) of § 1.72–6.

(ii) The exclusion ratio for the particular contract is then applied to the total amount received as an annuity during the taxable year by each recipient. See, however, paragraph (e) (3) of § 1.72–5. Any excess of the total amount received as an annuity during the taxable year over the amount determined by the application of the exclusion ratio to such total amount shall be included in the gross income of the recipient for the taxable year of receipt.

(2) The principles of subparagraph (1) may be illustrated by the following example:

Example. Taxpayer A purchased an annuity contract providing for payments of $100 per month for a consideration of $12,650. Assuming that the expected return under this contract is $16,000, the exclusion ratio to be used by A is $\frac{\$12,650}{\$16,000}$ or 79.1 percent (79.06 rounded to the nearest tenth). If 12 such monthly payments are received by A during his taxable year, the total amount he may exclude from his gross income in such year is $949.20 ($1,200×79.1 percent). The balance of $250.80 ($1,200 less $949.20) is the amount to be included in gross income. If A instead received only five such payments during the year, he should exclude $395.50 ($500×79.1 percent) of the total amounts received.

For an example of the computation of the exclusion ratio in cases where two annuity elements are acquired for a single consideration, see paragraph (b) (1) of § 1.72–6.

(3) The exclusion ratio shall be applied only to amounts received as an annuity within the meaning of that term under paragraph (b) (2) and (3) of § 1.72–2. Where the periodic payments increase in amount after the annuity starting date in a manner not provided by the terms of the contract at such date, the portion of such payments representing the increase is not an amount received as an annuity. For the treatment of amounts not received as an annuity, see section 72 (e) and § 1.72–11. For special rules where paragraph (b) (3) of § 1.72–2 applies to amounts received, see paragraph (d) (3) of this section.

(4) After an exclusion ratio has been determined for a particular contract, it shall be applied to any amounts received as an annuity thereunder unless or until one of the following occurs:

(i) The contract is assigned or transferred for a valuable consideration (see section 72 (g) and paragraph (a) of § 1.72–10;

(ii) The contract matures or is surrendered, redeemed, or discharged in accordance with the provisions of paragraph (c) or (d) of § 1.72–11;

(iii) The contract is exchanged (or is considered to have been exchanged) in a manner described in paragraph (e) of § 1.72–11.

(b) *Annuity starting date.* (1) Except as provided in subparagraph (2) of this paragraph, the annuity starting date is the first day of the first period for which an amount is received as an annuity, except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954. The first day of the first period for which an amount is received as an annuity shall be whichever of the following is the later:

(i) The date upon which the obligations under the contract became fixed, or

(ii) The first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

(2) Notwithstanding the provisions of subparagraph (1) of this paragraph, the

annuity starting date shall be determined in accordance with whichever of the following provisions is appropriate:

(i) In the case of a joint and survivor annuity contract described in section 72 (i) and paragraph (b) (3) of § 1.72–5, the annuity starting date is January 1, 1954, or the first day of the first period for which an amount is received as an annuity by the surviving annuitant, whichever is the later;

(ii) In the case of the transfer of an annuity contract for a valuable consideration, as described in section 72 (g) and paragraph (a) of § 1.72–10, the annuity starting date shall be January 1, 1954, or the first day of the first period for which the transferee received an amount as an annuity, whichever is the later; and

(iii) If the provisions of paragraph (e) of § 1.72–11 apply to an exchange of one contract for another, or to a transaction deemed to be such an exchange, the annuity starting date of the contract received (or deemed received) in exchange shall be January 1, 1954, or the first day of the first period for which an amount is received as an annuity under such contract, whichever is the later.

(c) *Fiscal year taxpayers.* Fiscal year taxpayers receiving amounts as annuities in a taxable year to which the Internal Revenue Code of 1954 applies shall determine the annuity starting date in accordance with section 72 (c) (4) and this section. The annuity starting date for fiscal year taxpayers receiving amounts as an annuity in a taxable year to which the Internal Revenue Code of 1939 applies shall be January 1, 1954, except where the first day of the first period for which an amount is received by such a taxpayer as an annuity is subsequent thereto and before the end of a fiscal year to which the Internal Revenue Code of 1939 applied. In such case, the latter date shall be the annuity starting date. In all cases where a fiscal year taxpayer received an amount as an annuity in a taxable year to which the Internal Revenue Code of 1939 applied and subsequent to the annuity starting date determined in accordance with the provisions of this paragraph, such amount shall be disregarded for the purposes of section 72 and the regulations thereunder.

(d) *Exceptions to the general rule.* (1) Where the provisions of section 72 would otherwise require an exclusion ratio to be determined, but the investment in the contract (determined under § 1.72–6) is an amount of zero or less, no exclusion ratio shall be determined and all amounts received under such a contract shall be includible in the gross income of the recipient for the purposes of section 72.

(2) Where the investment in the contract is equal to or greater than the total expected return under such contract found under § 1.72–5, the exclusion ratio shall be considered to be 100 percent and all amounts received as an annuity under such contract shall be excludable from the recipient's gross income. See, for example, paragraph (f) (1) of § 1.72–5.

(3) (i) If a contract provides for payments to be made to a taxpayer in the manner described in paragraph (b) (3) of § 1.72–2, the investment in the contract shall be considered to be equal to the expected return under such contract and the resulting exclusion ratio (100%) shall be applied to all amounts received as an annuity under such contract. For any taxable year, payments received under such a contract shall be considered to be amounts received as an annuity only to the extent that they do not exceed the portion of the investment in the contract which is properly allocable to that year and hence excludable from gross income as a return of premiums or other consideration paid for the contract. The portion of the investment in the contract which is properly allocable to any taxable year shall be determined by dividing the investment in the contract (adjusted for any refund feature in the manner described in paragraph (d) of § 1.72–7) by the applicable multiple (whether for a term certain, life, or lives) which would otherwise be used in determining the expected return for such a contract under § 1.72–5. The multiple shall be adjusted in accordance with the provisions of the table in paragraph (a) (2) of § 1.72–5, if any adjustment is necessary, before making the above computation. If payments are to be made more frequently than annually and the number of payments to be made in the taxable year in which the annuity begins are less than the number of payments to be made each year thereafter, the amounts considered received as an annuity (as otherwise determined under this subdivision) shall not exceed, for such taxable year (including a short taxable year), an amount which bears the same ratio to the portion of the investment in the contract considered allocable to each taxable year as the number of payments to be made in the first year bears to the number of payments to be made in each succeeding year. Thus, if payments are to be made monthly, only seven payments will be made in the first taxable year, and the portion of the investment in the contract allocable to a full year of payments is $600, the amounts considered received as an annuity in the first taxable year cannot exceed $350 ($600 x 7/12). See subdivision (iii) of this subparagraph for an example illustrating the determination of the portion of the investment in the contract allocable to one taxable year of the taxpayer.

(ii) If subdivision (i) of this subparagraph applies to amounts received by a taxpayer and the total amount of payments he receives in a taxable year is less than the total amount excludable for such year under subdivision (i) of this subparagraph, the taxpayer may elect, in a succeeding taxable year in which he receives another payment, to redetermine the amounts to be received as an annuity during the current and succeeding taxable years. This shall be computed in accordance with the provisions of subdivision (i) of this subparagraph except that:

(*a*) The difference between the portion of the investment in the contract allocable to a taxable year, as found in accordance with subdivision (i) of this subparagraph, and the total payments actually received in the taxable year prior to the election shall be divided by the life expectancy of the annuitant (or annuitants), found in accordance with the appropriate table in § 1.72–9 (and adjusted in accordance with paragraph (a) (2) of § 1.72–5), or by the remaining term of a term certain annuity, computed as of the first day of the first period for which an amount is received as an annuity in the taxable year of the election; and

(*b*) The amount determined under (*a*) of this subdivision shall be added to the portion of the investment in the contract allocable to each taxable year (as otherwise found). To the extent that the total periodic payments received under the contract in the taxable year of the election or any succeeding taxable year does not equal this total sum, such payments shall be excludable from the gross income of the recipient. To the extent such payments exceed the sum so found, they shall be fully includible in recipient's gross income.

See subdivision (iii) of this subparagraph for an example illustrating the redetermination of amounts to be received as an annuity and subdivision (iv) of this subparagraph for the method of making the election provided by this subdivision.

(iii) The application of the principles of this subparagraph may be illustrated by the following example:

Example. Taxpayer A, a 64 year old male, files his return on a calendar year basis and has a life expectancy of 15.6 years on June 30, 1954, the annuity starting date of a contract to which § 1.72–2 (b) (3) applies and which he purchased for $20,000. The contract provides for variable annual payments for his life. He receives a payment of $1,000 on June 30, 1955, but receives no other payment until June 30, 1957. He excludes the $1,000 payment from his gross income for the year 1955 since this amount is less than $1,324.50, the amount determined by dividing his investment in the contract ($20,000) by his life expectancy adjusted for annual payments, 15.1 (15.6—0.5), as of the original annuity starting date. Taxpayer A may elect, in his return for the taxable year 1957, to redetermine amounts to be received as an annuity under his contract as of June 30, 1956. For the purpose of determining the extent to which amounts received in 1957 or thereafter shall be considered amounts received as an annuity (to which a 100 percent exclusion ratio shall apply) he shall add $118.63 to the $1,324.50 originally determined to be receivable as an annuity under the contract, making a total of $1,443.13. This is determined by dividing the difference between what was excludable in 1955 and 1956, $2,649 (2×$1,324.50) and what he actually received in those years ($1,000) by his life expectancy adjusted for annual payments, 13.9 (14.4—0.5), as of his age at his nearest birthday (66) on the first day of the first period for which he received an amount as an annuity in the taxable year of election (June 30, 1956). The result, $1,443.13, is excludable in that year and each year thereafter as an amount received as an annuity to which the 100% exclusion ratio applies. It will be noted that in this example the taxpayer received amounts less than the excludable amounts in two successive years and deferred making his election until the third year, and thus was able to accumulate the portion of the investment in the contract allocable to each taxable year to the extent he failed to receive such portion in both years. Assuming that he received

$1,500 in the taxable year of his election, he would include $56.87 in his gross income and exclude $1,443.13 therefrom for that year.

(iv) If the taxpayer chooses to make the election described in subdivision (ii) of this subparagraph he shall file with his return a statement that he elects to make a redetermination of the amounts excludable from gross income under his annuity contract in accordance with the provisions of paragraph (d)(3) of § 1.72–4. This statement shall also contain the following information:

(*a*) The original annuity starting date and his age on that date,

(*b*) The date of the first day of the first period for which he received an amount in the current taxable year,

(*c*) The investment in the contract originally determined (as adjusted for any refund feature), and

(*d*) The aggregate of all amounts received under the contract between the date indicated in (*a*) of this subdivision and the day after the date indicated in (*b*) of this subdivision to the extent such amounts were excludable from gross income.

He shall include in gross income any amounts received during the taxable year for which the return is made in accordance with the redetermination made under this subparagraph.

(e) *Exclusion ratio in the case of two or more annuity elements acquired for a single consideration.* (1) (i) Where two or more annuity elements are provided under a contract described in paragraph (a) (2) of § 1.72–2, an exclusion ratio shall be determined for the contract as a whole and applied to all amounts received as an annuity under any of the annuity elements. To obtain this ratio, the investment in the contract determined in accordance with § 1.72–6 shall be divided by the aggregate of the expected returns found with respect to each of the annuity elements in accordance with § 1.72–5. For this purpose, it is immaterial that payments under one or more of the annuity elements involved have not commenced at the time when an amount is first received as an annuity under one or more of the other annuity elements.

(ii) The exclusion ratio found under subdivision (i) of this subparagraph does not apply to:

(*a*) An annuity element payable to a surviving annuitant under a joint and survivor annuity contract to which section 72 (i) and paragraphs (b) (3) and (e) (3) of § 1.72–5 apply, or to

(*b*) A contract under which one or more of the constituent annuity elements provides for payments described in paragraph (b) (3) of § 1.72–2.

For rules with respect to a contract providing for annuity elements described in (*b*) of this subdivision, see subparagraph (2) of this paragraph.

(2) If one or more of the annuity elements under a contract described in paragraph (a) (2) of § 1.72–2 provides for payments to which paragraph (b) (3) of § 1.72–2 applies:

(i) With respect to the annuity elements to which paragraph (b) (3) of § 1.72–2 does not apply, an exclusion ratio shall be determined by dividing the portion of the investment in the entire contract which is properly allocable to all such elements (in the manner provided in paragraph (b) (3) (ii) of § 1.72–6) by the aggregate of the expected returns thereunder and such ratio shall be applied in the manner described in subdivision (i) of subparagraph (1); and

(ii) With respect to the annuity elements to which paragraph (b) (3) of § 1.72–2 does apply, the investment in the entire contract shall be reduced by the portion thereof found in subdivision (i) of this subparagraph and the resulting amount shall be used to determine the extent to which the aggregate of the payments received during the taxable year under all such elements is excludable from gross income. The amount so excludable shall be allocated to each recipient under such elements in the same ratio that the total of the payments he receives each year bears to the total of the payments received by all such recipients during the year. The exclusion ratio with respect to the amounts so allocated shall be 100 percent. See paragraph (f) (2) of § 1.72–5 and paragraph (b) (3) of § 1.72–6.

§ 1.72–5 Expected return.

(a) *Expected return for but one life.* (1) If a contract to which section 72 applies provides that one annuitant is to receive a fixed monthly income for life, the expected return is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table I of § 1.72–9 under the age (as of annuity starting date) and sex of the measuring life (usually the annuitant's). Thus, where a male purchases a contract providing for an immediate annuity of $100 per month for his life and, as of the annuity starting date (in this case the date of purchase), the annuitant's age at his nearest birthday is 66, the expected return is computed as follows:

Monthly payment of $100×12 months equals annual payment of	$1,200
Multiple shown in Table I, male, age 66	14.4
Expected return ($1,200×14.0)	17,280

(2) (i) If payments are to be made quarterly, semiannually, or annually, an adjustment of the applicable multiple shown in Table I may be required. A further adjustment may be required where the interval between the annuity starting date and the date of the first payment is less than the interval between future payments. Neither adjustment shall be made, however, if the payments are to be made more frequently than quarterly. The amount of the adjustment, if any, is to be found in accordance with the following table:

If the number of whole months from the annuity starting date to the first payment date is—	0–1	2	3	4	5	6	7	8	9	10	11	12
And payments under the contract are to be made:												
Annually	+0.5	+0.4	+0.3	+0.2	+0.1	0	0	−0.1	−0.2	−0.3	−0.4	−0.5
Semiannually	+.2	+.1	0	0	−.1	−.2	------	------	------	------	------	------
Quarterly	+.1	0	−.1	------	------	------	------	------	------	------	------	------

Thus, for a male, age 66, the multiple found in Table I adjusted for quarterly payments the first of which is to be made one full month after the annuity starting date, is 14.5 (14.4+0.1); for semiannual payments the first of which is to be made six full months from the annuity starting date, the adjusted multiple is 14.2 (14.4—0.2); for annual payments the first of which is to be made one full month from the annuity starting date, the adjusted multiple is 14.9 (14.4+0.5). If the annuitant in the example shown in subparagraph (1) of this paragraph were to receive an annual payment of $1,200 commencing 12 full months after his annuity starting date, the amount of the expected return would be $16,680 ($1,200×13.9 [14.4—0.5]).

(ii) Notwithstanding the table in subdivision (i) of this subparagraph, adjustments of multiples for early or other than monthly payments determined prior to February 19, 1956, under the table prescribed in paragraph 1(b)(4) of T.D. 6118 (19 F.R. 9897, C.B. 1955–1, 699), approved December 30, 1954, need not be redetermined.

(3) If the contract provides for fixed payments to be made to an annuitant until death or until the expiration of a specified limited period, whichever occurs earlier, the expected return of such temporary life annuity is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table IV of § 1.72–9 for the age (as of the annuity starting date) and sex of the annuitant and the nearest whole number of years in the specified period. For example, if a male annuitant, age 60 (at his nearest birthday), is to receive $60 per month for five years or until he dies, whichever is earlier, the expected return under such a contract is $3,456, computed as follows:

Monthly payments of $60×12 months equals annual payment of	$720
Multiple shown in Table IV for male, age 60, for term of 5 years	4.8
Expected return for 5 year temporary life annuity of $720 per year ($720×4.8)	$3,456

The adjustment provided by subparagraph (2) of this paragraph shall not be made with respect to the multiple found in Table IV.

(4) If the contract provides for payments to be made to an annuitant for his lifetime, but the amount of the annual payments is to be decreased after the

expiration of a specified limited period, the expected return is computed by considering the contract as a combination of a whole life annuity for the smaller amount plus a temporary life annuity for an amount equal to the difference between the larger and the smaller amount. For example, if a male annuitant, age 60, is to receive $150 per month for five years or until his earlier death, and is to receive $90 per month for the remainder of his lifetime after such five years, the expected return is computed as if the annuitant's contract consisted of a whole life annuity for $90 per month plus a five year temporary life annuity of $60 per month. In such circumstances, the expected return is computed as follows:

Monthly payments of $90×12 months equals annual payment of	$1,080
Multiple shown in Table I for male, age 60	18.2
Expected return for whole life annuity of $1,080 per year	$19,656
Expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3) of this paragraph	3,456
Total expected return	23,112

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(5) If the contract described in subparagraph (4) of this paragraph provided that the amount of the annual payments to the annuitant were to be increased (instead of decreased) after the expiration of a specified limited period, the expected return would be computed as if the annuitant's contract consisted of a whole life annuity for the larger amount minus a temporary life annuity for an amount equal to the difference between the larger and smaller amount. Thus, if the annuitant described in subparagraph (4) of this paragraph were to receive $90 per month for five years or until his earlier death, and to receive $150 per month for the remainder of his lifetime after such five years, the expected return would be computed by subtracting the expected return under a five year temporary life annuity of $60 per month from the expected return under a whole life annuity of $150 per month. In such circumstances, the expected return is computed as follows:

Monthly payments of $150×12 months equals annual payment of	$1,800
Multiple shown in Table I (male, age 60)	18.2
Expected return for annuity for whole life of $1,800 per year	$32,760
Less expected return for 5-year temporary life annuity of $720 per year (as found in subparagraph (3))	3,456
Net expected return	29,304

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(b) *Expected return under joint and survivor and joint annuities.* (1) In the case of a joint and survivor annuity contract involving two annuitants which provides the first annuitant with a fixed monthly income for life and, after the death of the first annuitant, provides an identical monthly income for life to a second annuitant, the expected return shall be determined by multiplying the total amount of the payments to be received annually by the multiple obtained from Table II of § 1.72–9 under the ages (as of the annuity starting date) and sexes of the living annuitants. For example, a husband purchases a joint and survivor annuity contract providing for payments of $100 per month for life, and, after his death, for the same amount to his wife for the remainder of her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. The expected return is computed as follows:

Monthly payments of $100×12 months equals annual payment of	$1,200
Multiple shown in Table II (male, age 70; female, age 67)	19.7
Expected return ($1,200×19.7)	$23,640

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table II should be made in accordance with paragraph (a) (2) of this section.

(2) If a contract of the type described in subparagraph (1) of this paragraph provides that a different (rather than an identical) monthly income is payable to the second annuitant, the expected return is computed in the following manner. The applicable multiple in Table II is first found as in the example in subparagraph (1) of this paragraph. The multiple applicable to the first annuitant is then found in Table I as though the contract were for a single life annuity. The multiple from Table I is then subtracted from the multiple obtained from Table II and the resulting multiple is applied to the total payments to be received annually under the contract by the second annuitant. The result is the expected return with respect to the second annuitant. The portion of the expected return with respect to payments to be made during the first annuitant's life is then computed by applying the multiple found in Table I to the total annual payments to be received by such annuitant under the contract. The expected returns with respect to each of the annuitants separately are then aggregated to obtain the expected return under the entire contract.

Example. A husband purchases a joint and survivor annuity providing for payments of $100 per month for his life and, after his death, payments to his wife of $50 per month for her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67.

Multiple from Table II (male, age 70; female, age 67)	19.7
Multiple from Table I (male, age 70)	12.1
Difference (multiple applicable to second annuitant)	7.6
Portion of expected return, second annuitant ($600×7.6)	$4,560
Portion of expected return, first annuitant ($1,200×12.1)	14,520
Expected return under the contract	19,080

The expected return thus found, $19,080, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract in this example is $14,310, the exclusion ratio is $\frac{\$14,310}{\$19,080}$, or 75 percent. The amount excludable from each monthly payment made to the husband is 75 percent of $100, or $75, and the remaining $25 of each payment received by him shall be included in his gross income. After the husband's death, the amount excludable by the second annuitant (the surviving wife) would be 75 percent of each monthly payment of $50, or $37.50, and the remaining $12.50 of each payment shall be included in her gross income.

The same method is used if the payments are to be increased after the death of the first annuitant. Thus, if the payments to be made until the husband's death were $50 per month and his widow were to receive $100 per month thereafter until her death, the 7.6 multiple in the above example would be applied to the $100 payments, yielding an expected return with respect to this portion of the annuity contract of $9,120 ($1,200 x 7.6). An expected return of $7,260 ($600 x 12.1) would be obtained with respect to the payments to be made the husband, yielding a total expected return under the contract of $16,380 ($9,120 plus $7,260). If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiples found in Tables I and II should be made in accordance with paragraph (a) (2) of this section.

(3) In the case of a joint and survivor annuity contract in respect of which the first annuitant died in 1951, 1952, or 1953, and the basis of the surviving annuitant's interest in the contract was determinable under section 113 (a) (5) of the Internal Revenue Code of 1939, such basis shall be considered the "aggregate of premiums or other consideration paid" by the surviving annuitant for the contract. (For rules governing this determination, see 26 CFR (1939) 39.22(b)(2)–2 and 39.113(a)(5)–1 (Regulations 118).) In determining such an annuitant's investment in the contract, such aggregate shall be reduced by any amounts received under the contract by the surviving annuitant before the annuity starting date, to the extent such amounts were excludable from his gross income at the time of receipt. The expected return of the surviving annuitant in such cases shall be determined in the manner prescribed in paragraph (a) of this section, as though the surviving annuitant alone were involved. For this purpose, the appropriate multiple for the survivor shall be obtained from Table I as of the annuity starting date determined in accordance with paragraph (b) (2) (i) of § 1.72–4.

(4) If a contract involving two annuitants provides for fixed monthly payments to be made as a joint life annuity until the death of the first annuitant to die (in other words, only as long

as both remain alive), the expected return under such contract shall be determined by multiplying the total of the annuity payments to be received annually under the contract by the multiple obtained from Table IIA of § 1.72–9 under the ages (as of the annuity starting date) and sexes of the annuitants. If, however, payments are to be made under the contract quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table IIA shall be made in accordance with paragraph (a) (2) of this section.

(5) If a joint and survivor annuity contract involving two annuitants provides that a specified amount shall be paid during their joint lives and a different specified amount shall be paid to the survivor upon the death of whichever of the annuitants is the first to die, the following preliminary computation shall be made in all cases preparatory to determining the expected return under the contract:

(i) From Table II, obtain the multiple under both of the annuitants' ages (as of the annuity starting date) and their appropriate sexes;

(ii) From Table IIA, obtain the multiple applicable to both annuitants' ages (as of the annuity starting date) and their appropriate sexes;

(iii) Apply the multiple found in subdivision (i) of this subparagraph to the total of the amounts to be received annually after the death of the first to die; and

(iv) Apply the multiple found in subdivision (ii) of this subparagraph to the difference between the total of the amounts to be received annually before and the total of the amounts to be received annually after the death of the first to die.

If the original annual payment is in excess of the annual payment to be made after the death of the first to die, the expected return is the sum of the amounts determined under subdivisions (iii) and (iv) of this subparagraph. This may be illustrated by the following example:

Example. A husband purchases a joint and survivor annuity providing for payments of $100 a month for as long as both he and his wife live, and, after the death of the first to die, payments to the survivor of $75 a month for life. As of the annuity starting date, his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. The expected return under the contract is computed as follows:

Multiple from Table II (male, age 70; female, age 67)	19.7
Multiple from Table IIA (male, age 70; female, age 67)	9.3
Portion of expected return ($900 × 19.7—sum per year after first death)	$17,730
Portion of expected return ($300 × 9.3—amount of change in sum at first death)	2,790
Expected return under the contract	20,520

The total expected return in this example, $20,520, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract is $17,887, the exclusion ratio is $\frac{\$17,887}{\$20,520}$, or 87.2 percent. The amount excludable from each monthly payment made while both are alive is 87.2 percent of $100, or $87.20 and the remaining $12.80 of each payment shall be included in gross income. After the death of the first to die, the amount excludable by the survivor shall be 87.2 percent of each monthly payment of $75, or $65.40, and the remaining $9.60 of each payment shall be included in gross income.

If the original annual payment is less than the annual payment to be made after the death of the first to die, the expected return is the difference between the amounts determined under subdivisions (iii) and (iv) of this subparagraph. If, however, payments are to be made quarterly, semiannually, or annually under the contract, the multiples obtained from both Tables II and IIA shall first be adjusted in a manner prescribed in paragraph (a)(2) of this section.

(6) If a contract provides for the payment of life annuities to two persons during their respective lives and, after the death of one (without regard to which one dies first), provides that the survivor shall receive for life both his own annuity payments and the payments made formerly to the deceased person, the expected return shall be determined in accordance with paragraph (e) (4) of this section.

(7) If paragraph (b)(3) of § 1.72–2 applies to payments provided under a contract and this paragraph applies to such payments, the principles of this paragraph shall be used in making the computations described in paragraph (d) (3) of § 1.72–4. This may be illustrated by the following examples:

Example (1). Taxpayer A, a male age 63, pays $24,000 for a contract which provides that the proceeds (both income and return of capital) from eight units of an investment fund shall be paid monthly to him for his life and that after his death the proceeds from six such units shall be paid monthly to B, a female age 55, for her life, the portion of the investment in the contract allocable to each taxable year of A is $955.20 and that allocable to each taxable year of B is $716.40. This is determined in the following manner:

Multiple from Table II (male, age 63; and female, age 55)	28.1
Number of units to be paid, in effect, as a joint and survivor annuity	×6
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element	168.6
Multiple from Table I (male, age 63)	16.2
Number of units to be paid in effect, as a single life annuity	×2
Number of total annual unit payments anticipatable with respect to A alone	32.4
Total number of unit payments anticipatable	201
Portion of investment in the contract allocable to unit payments ($24,000÷201) on an annual basis	$119.40
Number of units payable to A while he continues to live	×8
Portion of the investment in the contract allocable to each taxable year of A	955.20
Portion of investment in the contract allocable to unit payments ($24,000÷201) on an annual basis	$119.40
Number of units payable to B for her life after A's death	×6
Portion of the investment in the contract allocable to each taxable year of B	716.40

For the purpose of the above computation it is immaterial whether or not A lives to or beyond the life expectancy shown for him in Table I.

Example (2). Assume that Taxpayer A in example (1) receives payments for five years which are at least as large as the portion of the investment in the contract allocable to such years, but in the sixth year he receives a total on only $626.40 rather than the $955.20 allocable to such year. A is 69 and B is 61 at the beginning of the first monthly period for which an amount is payable in the seventh taxable year. A makes the election in that year provided under paragraph (d)(3) of § 1.72–4. The difference between the portion of the investment in the contract allocable to the sixth year and the amount actually received in that year is $328.80 ($955.20 less $626.40). In this case, 139.2 unit payments are anticipatable (on an annual basis), since the appropriate multiple from Table II of § 1.72–9, 23.2, multiplied by the number of units payable, in effect, as a joint and survivor annuity yields this result (6×23.2). A's appropriate multiple from Table I of § 1.72–9 for the two units which will cease to be paid at his death is 12.6, and the total number of unit payments anticipatable (on an annual basis) is, therefore, 164.4 (2×12.6 plus 139.2). Dividing the difference previously found ($328.80) by the total number of unit payments thus determined (164.4) indicates that A will have an additional allocation of the investment in the contract of $16 to the seventh and every succeeding full taxable year (8 units×$2), and B will have an additional allocation of the investment in the contract of $12 (6 units×$2) to each taxable year in which she receives 12 monthly payments subsequent to the death of A. The total allocable to each taxable year of A is, therefore, $971.20, and that allocable to each taxable year of B will be $728.40.

Example (3). If, in example (2), A had died at the end of the fifth year, in the sixth year B would have received a payment of $469.80 (that portion of the $626.40 that A would have received which is in the same ratio that 6 units bear to 8 units) and would thus have received $246.60 less than the portion of the investment in the contract originally determined to be allocable to each of her taxable years. In these circumstances, B would be entitled to elect to redetermine the portion of the investment in the contract allocable to the taxable year of election and all subsequent years. The new amount allocable thereto would be found by dividing the $246.60 difference by her life expectancy as of the first day of the first period for which she received an amount as an annuity in the seventh year of the annuity contract, and adding the result to her originally determined allocation of $716.40.

(c) *Expected return for term certain.* In the case of a contract providing for specific periodic payments which are to be paid for a term certain such as a fixed number of months or years, without regard to life expectancy, the expected return is determined by multiplying the fixed number of years or months for which payments are to be made on or

after the annuity starting date by the amount of the payment provided in the contract for each such period.

(d) *Expected return with respect to amount certain.* In the case of contracts involving no life or lives as a measurement of their duration, but under which a determinable total amount is to be paid in installments of lesser amounts paid at periodic intervals, the expected return shall be the total amount guaranteed. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, this paragraph shall apply to the total amount anticipatable as a result of the amount of the fund plus the fixed interest thereon. Any amount which may be paid as the result of earnings at a greater interest rate shall be disregarded in determining the expected return. If such an amount is later received, it shall be considered an amount not received as an annuity after the annuity starting date. See paragraph (b) (2) of § 1.72–11.

(e) *Expected return where two or more annuity elements providing for fixed payments are acquired for a single consideration.* (1) In the case of a contract described in paragraph (a) (2) of § 1.72–2, which provides for specified payments to be made under two or more annuity elements, the expected return shall be found for the contract as a whole by aggregating the expected returns found with respect to each annuity element. If individual life annuity elements are involved (including joint and survivor annuities where the primary annuitant died before January 1, 1954) expected return for each of them shall be determined in the manner prescribed in paragraph (a) of this section. If joint and survivor annuity elements are involved, the expected return for such elements shall be determined under the appropriate subparagraph of paragraph (b) of this section. If terms certain or amounts certain are involved, the expected returns for such elements shall be determined under paragraph (c) or (d) of this section, respectively.

(2) The aggregate expected return found in accordance with the rules set forth in subparagraph (1) of this paragraph shall constitute the expected return for the contract as a whole. The investment in the contract shall be divided by the amount thus determined to obtain the exclusion ratio for the contract as a whole. This exclusion ratio shall be applied to all amounts received as an annuity under the contract by any recipient (in accordance with the provisions of § 1.72–4), except in the case of amounts received by a surviving annuitant under a joint and survivor annuity element to which the provisions of section 72(i) and paragraph (b)(3) of this section would apply if it were a separate contract. See subparagraph (3) of this paragraph.

(3) In the case of a contract providing two or more annuity elements, one of which is a joint and survivor annuity element of the type described in section 72 (i) and paragraph (b) (3) of this section, the general exclusion ratio for the contract as a whole, for the purpose of computations with respect to all the other annuity elements, shall be determined in accordance with the principles of subparagraphs (1) and (2) of this paragraph. A special exclusion ratio shall thereafter be determined for the surviving annuitant receiving payments under the annuity element described in section 72 (i) and paragraph (b) (3) of this section by using the investment in the contract and the expected return determined in accordance with the provisions of paragraph (b) (3) of this section.

(4) In the case of a contract providing for payments to be made to two persons in the manner described in paragraph (b) (6) of § 1.72–5, the expected return is to be computed as though there were two joint and survivor annuities under the same contract, in the following manner. First, the multiple appropriate to the ages (as of the annuity starting date) and sexes of the annuitants involved shall be found in Table II of § 1.72–9 and adjusted, if necessary, in the manner described in paragraph (a) (2) of this section. Second, the multiple so found shall be applied to the sum of the payments to be made each year to both annuitants. The result is the expected return for the contract as a whole.

(5) For rules relating to expected return where two or more annuity elements are acquired for a single consideration and one or more of such elements does not specify a fixed payment for each period, see paragraph (f) of this section.

(f) *Expected return with respect to obligations providing for payments described in paragraph (b) (3) of § 1.72–2.* (1) If a contract to which section 72 applies provides only for payments to be made in a manner described in paragraph (b) (3) of § 1.72–2, the expected return for such contract as a whole shall be an amount equal to the investment in the contract found in accordance with section 72 (c) (1) and § 1.72–6, as adjusted for any refund feature in accordance with § 1.72–7.

(2) If a contract to which section 72 applies provides for annuity elements, one or more of which (but not all) provide for payments to be made in a manner described in paragraph (b) (3) of § 1.72–2:

(i) With respect to the portion of the contract providing for annuity elements to which paragraph (b) (3) of § 1.72–2 does not apply, the expected return shall be the aggregate of the expected returns found for each of such elements in accordance with the appropriate paragraph of this section; and

(ii) With respect to all annuity elements to which paragraph (b) (3) of § 1.72–2 does apply, the expected return for all such elements shall be an amount equal to the portion of the investment in the contract allocable to such elements in accordance with the provisions of paragraph (e) (2) (ii) of § 1.72–4 and paragraph (b) (3) (ii) (b) of § 1.72–6.

§ 1.72–6 Investment in the contract.

(a) *General rule.* (1) For the purpose of computing the "investment in the contract", it is first necessary to determine the "aggregate amount of premiums or other consideration paid" for such contract. See section 72 (c) (1). This determination is made as of the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity. The amount so found is then reduced by the sum of the following amounts in order to find the investment in the contract:

(i) The total amount of any return of premiums or dividends received (including unrepaid loans or dividends applied against the principal or interest on such loans) on or before the date on which the foregoing determination is made, and

(ii) The total of any other amounts received with respect to the contract on or before such date which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.

Amounts to which subdivision (ii) of this subparagraph applies shall include, for example, amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code. For rules relating to the extent to which an employee or his beneficiary may include employer contributions in the aggregate amount of premiums or other consideration paid, see § 1.72–8.

(2) For the purpose of subparagraph (1) of this paragraph, amounts received subsequent to the receipt of an amount as an annuity or subsequent to the annuity starting date, whichever is the later, shall be disregarded. See, however, § 1.72–11.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). In 1950, B purchased an annuity contract for $10,000 which was to provide him with an annuity of $1,000 per year for life. He received $1,000 in each of the years 1950, 1951, 1952, and 1953, prior to the annuity starting date (January 1, 1954). Under the Internal Revenue Code of 1939, $300 of each of these payments (3 percent of $10,000) was includible in his gross income, and the remaining $700 was excludable therefrom during each of the taxable years mentioned. In computing B's investment in the contract as of January 1, 1954, the total amount excludable from his gross income during the years 1950 through 1953 ($2,800) must be subtracted from the consideration paid ($10,000). Accordingly, B's investment in the contract as of January 1, 1954, is $7,200 ($10,000 less $2,800).

Example (2). In 1945, C contracted for an annuity to be paid to him beginning December 31, 1960. In 1945 and in each successive year until 1960, he paid a premium of $5,000. Assuming he receives no payments of any kind under the contract until the date on which he receives the first annual payment as an annuity (December 31, 1960), his investment in the contract as of the annuity starting date (December 31, 1959) will be $75,000 ($5,000 paid each year for the 15 years from 1945 to 1959, inclusive).

Example (3). Assume the same facts as in example (2), except that prior to the annuity starting date C has already received from the insurer dividends of $1,000 each in 1949, 1954, and 1959, such dividends not being includible in his gross income in any of those years. C's investment in the contract, as

of the annuity starting date, will then be $72,000 ($75,000—$3,000).

(b) *Allocation of the investment in the contract where two or more annuity elements are acquired for a single consideration.* (1) In the case of a contract described in § 1.72–2 (a) (2) which provides for two or more annuity elements, the investment in the contract determined under paragraph (a) shall be allocated to each of the annuity elements in the ratio that the expected return under each annuity element bears to the aggregate of the expected returns under all the annuity elements. The exclusion ratio for the contract as a whole shall be determined by dividing the investment in the contract (after adjustment for the present value of any or all refund features) by the aggregate of the expected returns under all the annuity elements. Thus, if a contract provides for annuity payments of $1,000 per year for life (with no refund feature) to both A and B, a male and female, respectively, each 70 years of age as of the annuity starting date, and such contract is acquired for consideration of $19,575 (without regard to whether paid by A, B, or both), the investment in the contract shall be allocated by determining the exclusion ratio for the contract as a whole in the following manner:

Expectancy of A under Table I and § 1.72–5 (a) (2), 11.6 (12.1—0.5), multiplied by $1,000	$11,600
Expectancy of B computed in a similar manner ($1,000×14.5 [15.0—0.5])	14,500
Total expected return	26,100

The exclusion ratio for both A and B is then $\frac{\$19,575}{\$26,100}$, or 75 percent. A and B shall each exclude from gross income three-fourths ($750) of each $1,000 annual payment received and shall include the remaining one-fourth ($250) of each $1,000 annual payment received in gross income.

(2) In the case of a contract providing for specified annual annuity payments to be made to two persons during their joint lives and the payment of the aggregate of the two individual payments to the survivor for his life, the investment in the contract shall be allocated in accordance with the provisions of subparagraph (1) of this paragraph. For this purpose, the investment in the contract (without regard to the fact that differing amounts may have been contributed by the two annuitants) shall be divided by the expected return determined in accordance with paragraph (c) (4) of § 1.72–5. The resulting exclusion ratio shall then be applied to any amounts received as an annuity by either annuitant.

(3) In the case of a contract providing two or more annuity elements, one or more of which provides for payments to be made in a manner described in paragraph (b) (3) of § 1.72–2, the investment in the contract shall be allocated to the various annuity elements in the following manner:

(i) If all the annuity elements provide for payments to be made in the manner described in paragraph (b) (3) of § 1.72–2, the investment in the contract shall be allocated on the basis of the amounts received by each recipient by apportioning the amount determined to be excludable under that section to each recipient in the same ratio as the total of the amounts received by him in his taxable year bears to the total of the amounts received by all recipients during the same period; and

(ii) If one or more, but not all, of the annuity elements provide for payments to be made in a manner described in paragraph (b) (3) of § 1.72–2:

(*a*) With respect to all annuity elements to which that section does not apply, the investment in the contract for all such elements shall be the portion of the investment in the contract as a whole (found in accordance with the provisions of this section) which is properly allocable to all such elements; and

(*b*) With respect to all annuity elements to which paragraph (b) (3) of § 1.72–2 does apply, the investment in the contract for all such elements shall be the investment in the contract as a whole (found in accordance with the provisions of this section) as reduced by the portion thereof determined under (*a*) of this subdivision.

For the purpose of determining, pursuant to (*a*) of this subdivision, the portion of the investment in the contract as a whole properly allocable to a particular annuity element, reference shall be made to the present value of such annuity element determined in accordance with paragraph (e) (1) (iii) (*b*) of § 1.101–2.

(c) *Special rules.* (1) For the special rule for determining the investment in the contract for a surviving annuitant in cases where the prior annuitant of a joint and survivor annuity contract died in 1951, 1952, or 1953, see paragraph (b) (3) of § 1.72–5.

(2) For special rules relating to the determination of the investment in the contract where employer contributions are involved, see § 1.72–8. See also paragraph (a) (3) (i) of § 1.402 (a)–1 for a special rule relating to the determination of the premiums or other consideration paid for a contract where an employee is taxable on the premiums paid for life insurance protection that is purchased by and considered to be a distribution from an exempt employees' trust.

(3) For the determination of an adjustment in investment in the contract in cases where a contract contains a refund feature, see § 1.72–7.

§ 1.72–7 Adjustment in investment where a contract contains a refund feature.

(a) *Definition of a contract containing a refund feature.* A contract to which section 72 applies, contains a refund feature if:

(1) The total amount receivable as an annuity under such contract depends, in whole or in part, on the continuing life of one or more persons,

(2) The contract provides for payments to be made to a beneficiary or the estate of an annuitant on or after the death of the annuitant if a specified amount or a stated number of payments has not been paid to the annuitant or annuitants prior to death, and

(3) Such payments are in the nature of a refund of the consideration paid. See paragraph (c) (1) of § 1.72–11.

(b) *Adjustment of investment for the refund feature in the case of a single life annuity.* Where a single life annuity contract to which section 72 applies contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(1) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract to the extent such amount reduces the guaranteed amount. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(2) Consult Table III of § 1.72–9 for the appropriate percentage under the whole number of years found in subparagraph (1) of this paragraph and the age (as of the annuity starting date) and sex of the annuitant.

(3) Multiply the percentage found in subparagraph (2) of this paragraph by whichever of the following is the smaller: (i) The investment in the contract found in accordance with § 1.72–6 or (ii) the total amount guaranteed as of the annuity starting date.

(4) Subtract the amount found in subparagraph (3) of this paragraph from the investment in the contract found in accordance with § 1.72–6.

The resulting amount is the investment in the contract adjusted for the present value of the refund feature without discount for interest and is to be used in determining the exclusion ratio to be applied to the payments received as an annuity. The percentage found in Table III shall not be adjusted in a manner described in paragraph (a) (2) of § 1.72–5. These principles may be illustrated by the following example:

Example. On January 1, 1954, a husband, age 65, purchased for $21,053, an immediate installment refund annuity payable $100 per month for life. The contract provided that in the event the husband did not live long enough to recover the full purchase price, payments were to be made to his wife until the total payments under the contract equaled the purchase price. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)		$21,053
Amount to be received annually	$1,200	
Number of years for which payment guaranteed ($21,053 divided by $1,200)	17.5	
Rounded to nearest whole number of years	18	
Percentage located in Table III for age 65 (age of the annuitant as of the annuity starting date) and 18 (the number of whole years) (percent)	30	
Subtract value of the refund fea-		

Subtract value of the refund feature to the nearest dollar (30 percent of $21,053)	$6,316
Investment in the contract adjusted for the present value of the refund feature without discount for interest	14,737

If, in the above example, the guaranteed amount had exceeded the investment in the contract, the percentage found in Table III should have been applied to the lesser of these amounts since any excess of the guaranteed amount over the investment in the contract (as found under § 1.72–6) would not have constituted a refund of premiums or other consideration paid. In such a case, however, a different multiple might have been obtained from Table III since the number of years for which payments were guaranteed would have been greater.

(c) *Adjustment of investment for the refund feature in the case of a joint and survivor annuity.* (1) Where a joint and survivor annuity contract described in paragraph (b) (1) or (6) of § 1.72–5 contains a refund feature and the special rule of paragraph (d) of this section does not apply, the investment in the contract shall be adjusted in the following manner:

(i) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(ii) Consult Table III of § 1.72–9 for the appropriate percentages under the whole number of years found in subdivision (i) of this subparagraph and the age (as of the annuity starting date) and sex of each annuitant. If the annuitants are not of the same sex, substitute for the female annuitant a male annuitant 5 years younger, or for the male annuitant a female annuitant 5 years older, so that Table III will be entered in both cases with the ages of annuitants of the same sex.

(iii) Find the sum of the two percentages found in accordance with subdivision (ii) of this subparagraph.

(iv) To the age of the elder of the two annuitants (as determined under subdivision (ii) of this subparagraph), add the number of years (indicated in the table below) opposite the number of years by which such annuitants' ages differ:

Number of years difference in age (2 male annuitants or 2 female annuitants)	Addition to older age in years
0 to 1, inclusive	9
2 to 3, inclusive	8
4 to 5, inclusive	7
6 to 8, inclusive	6
9 to 11, inclusive	5
12 to 15, inclusive	4
16 to 20, inclusive	3
21 to 27, inclusive	2
28 to 42, inclusive	1
Over 42	0

(v) Consult Table III for the appropriate percentage under the whole number of years found in subdivision (i) of this subparagraph and the sex and age of the elder annuitant as adjusted under subdivision (iv) of this subparagraph.

(vi) Subtract the percentage obtained in subdivision (v) of this subparagraph from the sum of the percentages found under subdivision (iii)) of this subparagraph. If the result is less than one, subdivisions (vii) and (viii) of this subparagraph shall be disregarded and no adjustment made to the investment in the contract.

(vii) Multiply the percentage found in subdivision (vi) of this subparagraph by whichever of the following is the smaller: (*a*) the investment in the contract found in accordance with § 1.72–6 or (*b*) the total amount guaranteed as of the annuity starting date.

(viii) Subtract the amount found in subdivision (vii) of this subparagraph from the investment in the contract found in accordance with § 1.72–6.

(2) The computation provided in subparagraph (1) of this paragraph for a case to which it applies may be illustrated by the following example:

Example. A husband, age 70, purchases a joint and last survivor annuity for $33,050. The contract provides for payments of $100 a month to be paid first to himself for life and then to B, his 40-year-old daughter, if she survives him. The contract further provides that in the event both die before ten years' payments have been made, payments will be continued to C, a beneficiary, or to C's estate, until ten years' payments have been made. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)		$33,050
Guaranteed amount ($1,200 × 10)	$12,000	
Percentage in Table III for male, age 70 (or female, age 75) for duration of the guarantee (10)	21	
Percentage in Table III for female, age 40 (or male, age 35) for duration of the guarantee (10)	2	
Sum of percentages obtained	23	
Difference in years of age between two males, aged 70 and 35 (or 2 females, aged 75 and 40)	35	
Addition, in years, to older age	1	
Percentage in Table III for male one year older than the husband	22	
Difference between percentages obtained (23 percent less 22 percent)	1	
Value of the refund feature to the nearest dollar (1 percent of $12,000)		$120
Investment in the contract adjusted for present value of the refund feature		32,930

(d) *Adjustment of investment in the contract where paragraph (b) (3) of § 1.72–2 applies to payments.* (1) If paragraph (b) (3) of § 1.72–2 applies to payments to be made under a contract and this section also applies because of the provision for a refund feature, an adjustment shall be made to the investment in the contract in accordance with this paragraph before making the computations required by paragraph (d) (3) of § 1.72–4 and paragraph (b) (7) of § 1.72–5. In the case of the guarantee of a specified amount, the adjustment shall be made by applying the appropriate multiple from Table III, as otherwise determined under this section, to the investment in the contract or the guaranteed amount, whichever is the lesser. The guarantee period shall be found by dividing the amount guaranteed by an amount determined by placing the payments received during the first taxable year (to the extent such payments reduce the guaranteed amount) on an annual basis. Thus, if monthly payments are first received by a taxpayer on a calendar year basis in August, his total payments (to the extent that they reduce the guaranteed amount) for the taxable year would be divided by 5 and multiplied by 12. The guaranteed amount would then be divided by the result of this computation to obtain the guarantee period. If the contract merely guarantees that proceeds from a unit or units of a fund shall be paid for a fixed number of years or the life (or lives) of an annuitant (or annuitants), whichever is the longer, the fixed number of years is the guarantee period. The appropriate percentage in Table III shall be applied to whichever of the following is the smaller: (i) the investment in the contract; or (ii) the product of the payments received in the first taxable year, placed on an annual basis, multiplied by the number of years for which payment of the proceeds of a unit or units is guaranteed.

(2) The principles of this paragraph may be illustrated by the following example:

Example. Taxpayer A, a 50-year-old male, purchases for $25,000, a contract which provides for variable monthly payments to be paid to him for his life. The contract also provides that if he should die before receiving payments for fifteen years, payments shall continue according to the original formula to his estate or beneficiary until payments have been made for that period. Beginning with the month of September, A receives payments which total $450 for the first taxable year of receipt. This amount, placed on an annual basis, is $1,350 ($450 divided by 4, or $112.50; $112.50 multiplied by 12, or $1,350). The guaranteed amount is considered to be $20,250 ($1,350 × 15), and the multiple from Table III (found in the same manner as in paragraph (b) of this section), 9 percent, applied to $20,250 (since this amount is less than the investment in the contract), results in a refund adjustment of $1,822.50. The latter amount, subtracted from the investment in the contract of $25,000, results in an adjusted investment in the contract of $23,177.50. If A dies before receiving payments for 15 years and the remaining payments are made to B, his beneficiary, B shall exclude the entire amount of such payments from his gross income until the amounts so received by B, together with the amounts received by A and excludable from A's gross income, equal or exceed $25,000. Any excess and any payments thereafter received by B shall be fully includible in gross income.

(e) *Adjustment of the investment in the contract where more than one annuity element is provided for a single*

consideration. In the case of contracts to which paragraph (b) of § 1.72–6 applies for the purpose of allocating the investment in the contract to two or more annuity elements which are provided for a single consideration, if one or more of such elements involves a refund feature, the portion of the investment in the contract properly allocable to each such element shall be adjusted for the refund feature before aggregating all the investments in order to obtain the exclusion ratio which is to apply to the contract as a whole. For example, if Taxpayer A, an insured 70 years of age, upon maturity of an endowment policy which cost him a net amount of $86,000, elected a dual settlement consisting of (1) monthly payments for his life aggregating $4,146 per year with 10 years' payments certain, and (2) monthly payments for his 60 year old brother, B, aggregating $2,820 per year with 20 years' payments certain, the exclusion ratio to be used by both A and B would be determined in the following manner:

A's expected return (A's payments per year of $4,146 multiplied by his life expectancy from Table I of 12.1)	$50,166.60
B's expected return (B's payments per year of $2,820 multiplied by his life expectancy from Table I of 18.2)	51,324.00
Sum of expected returns to be used in determining exclusion ratio	101,490.60
Percentage of total expected return attributable to A's expectancy of life ($50,166.60÷$101,490.60)	49.4
Percentage of total expected return attributable to B's expectancy of life ($51,324÷$101,490.60)	50.6
Portion of investment in the contract allocable to A's annuity (49.4 percent of $86,000)	42,484.00
Portion of investment in the contract allocable to B's annuity (50.6 percent of $86,000)	43,516.00
Value of the refund feature with respect to A's annuity (percentage from Table III for male, age 70, and duration 10, or 21 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $41,360)	8,707.00
A's allocable portion of the investment in the contract adjusted for refund feature ($42,484 less $8,707.00)	$33,777.00
Value of the refund feature with respect to B's annuity (percentage from Table III for male, age 60, and duration 20, or 25 percent, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $43,516)	10,879.00
B's allocable portion of the investment in the contract adjusted for refund feature ($43,516 less $10,879.00)	32,637.00
Sum of A's and B's allocable portions of the investment in the contract after adjustment for the refund feature	66,414.00
Exclusion ratio for the contract as a whole (total adjusted investment in the contract, $66,414, divided by the total expected return from above, $101,490.60) (percent)	65.4

paragraphs (a) and (b) of this section.

§ 1.72–8 Effect of certain employer contributions with respect to premiums or other consideration paid or contributed by an employee.

(a) *Contributions in the nature of compensation.* (1) Section 72(f) provides that, for the purposes of section 72 (c), (d), and (e), amounts contributed by an employer for the benefit of an employee or his beneficiaries shall constitute consideration paid or contributed by the employee to the extent that:

(i) Such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws, or

(ii) Such amounts would not have been includible in the gross income of the employee at the time contributed had they been paid directly to the employee at that time.

Amounts to which subdivision (i) of this subparagraph applies include, for example, contributions made by an employer to or under a trust or plan which fails to qualify under the provisions of section 401 (a), provided that the employee's rights to such contributions or under the plan are nonforfeitable at the time the contributions are made. See sections 402 (b) and 403 (b) and the regulations thereunder. This subdivision also applies to premiums paid by an employer for life insurance protection for an employee if such premiums are includible in the gross income of the employee when paid. See paragraph (d) of § 1.403 (a)–1. However, such premiums shall only be considered as premiums and other consideration paid by the employee with respect to any benefits attributable to the contract providing the life insurance protection. See paragraph (a) (3) (i) of § 1.402 (a)–1. Amounts to which subdivision (ii) of this subparagraph applies include, for example, contributions made by an employer after December 31, 1950, if made on account of foreign services rendered by an employee during a period in which the employee qualified as a bona fide resident of a foreign country under section 911(a) of the Internal Revenue Code of 1954 or under section 116(a) of the Internal Revenue Code of 1939. In such a case, it would be immaterial whether such contributions were made under a qualified plan or otherwise. On the other hand, if contributions are made by an employer to a qualified plan at a time when compensation paid directly to the employee concerned with respect to the same services rendered would have been includible in the gross income of the employee, such as in the case of an employee of a State government where contributions are made in 1955 with respect to services rendered by the employee prior to the year 1939, subdivision (ii) of this subparagraph does not apply to such contributions. If contributions made by an employer are made with respect to both foreign service and domestic service of the employee, subdivision (ii) of this subparagraph shall apply only to the portion of the contributions of the employer which bears the same ratio to the total employer contributions as the total other compensation of the employee attributable to his foreign service bears to the total other compensation paid to the employee for both his foreign and domestic services and shall in no event exceed the amount which would have been excludable if paid directly to the employee as compensation.

(2) Amounts contributed by an employer which were not includible in the gross income of the employee under this subtitle or prior income tax laws, but which would have been includible therein had they been paid directly to the employee, do not constitute consideration paid or contributed by the employee for the purposes of section 72. For example, contributions made by an employer under a qualified employees' trust or plan, which contributions would have been includible in the gross income of the employee had such contributions been paid to him directly as compensation, do not constitute consideration paid or contributed by the employee. Accordingly, the aggregate amount of premiums or other consideration paid or contributed by an employee, insofar as compensatory employer contributions are concerned, consists solely of the (i) sum of all amounts actually contributed by the employee, plus (ii) contributions in the nature of compensation which are deemed to be paid or contributed by the employee under subparagraph (1) of this paragraph.

(b) *Contributions in the nature of death benefits.* In the case of an employee's beneficiary, the aggregate amount of premiums or other consideration paid or deemed to be paid or contributed by the employee shall also include:

(1) Amounts (other than amounts paid as an annuity) to the extent such amounts are excludable from the beneficiary's gross income as a death benefit under section 101 (b), and

(2) Any amount or amounts of death benefits which are treated as additional consideration contributed by the employee under section 101 (b) (2) (D) and the regulations thereunder, or which were excludable from the beneficiary's gross income as a death benefit under section 22 (b) (1) (B) of the Internal Revenue Code of 1939 and the regulations thereunder.

Accordingly, in the case of an employee's beneficiary, any such amount shall be added to any amount or amounts deemed paid or contributed by the employee under paragraph (a) (1) of this section and to any amounts actually contributed by the employee for the purpose of finding the aggregate amount of premiums or other consideration paid or contributed by the employee.

(c) *Amounts "made available" to an employee or his beneficiary.* Any amount which, although not actually paid, is made available to and includible in the gross income of an employee or his beneficiary under the rules of sections 402 and 403 and the regulations thereunder, shall be considered an amount contributed by the employee and shall be aggregated with amounts, if any, to which

paragraphs (a) and (b) of this section apply for the purpose of determining the aggregate amount of premiums or other consideration paid by the employee.

§ 1.72–9 Tables.

The following tables are to be used in connection with computations under section 72 and the regulations thereunder:

TABLE I—ORDINARY LIFE ANNUITIES—ONE LIFE—EXPECTED RETURN MULTIPLES

Ages		Multiples	Ages		Multiples	Ages		Multiples
Male	Female		Male	Female		Male	Female	
6	11	65.0	41	46	33.0	76	81	9.1
7	12	64.1	42	47	32.1	77	82	8.7
8	13	63.2	43	48	31.2	78	83	8.3
9	14	62.3	44	49	30.4	79	84	7.8
10	15	61.4	45	50	29.6	80	85	7.5
11	16	60.4	46	51	28.7	81	86	7.1
12	17	59.5	47	52	27.9	82	87	6.7
13	18	58.6	48	53	27.1	83	88	6.3
14	19	57.7	49	54	26.3	84	89	6.0
15	20	56.7	50	55	25.5	85	90	5.7
16	21	55.8	51	56	24.7	86	91	5.4
17	22	54.9	52	57	24.0	87	92	5.1
18	23	53.9	53	58	23.2	88	93	4.8
19	24	53.0	54	59	22.4	89	94	4.5
20	25	52.1	55	60	21.7	90	95	4.2
21	26	51.1	56	61	21.0	91	96	4.0
22	27	50.2	57	62	20.3	92	97	3.7
23	28	49.3	58	63	19.6	93	98	3.5
24	29	48.3	59	64	18.9	94	99	3.3
25	30	47.4	60	65	18.2	95	100	3.1
26	31	46.5	61	66	17.5	96	101	2.9
27	32	45.6	62	67	16.9	97	102	2.7
28	33	44.6	63	68	16.2	98	103	2.5
29	34	43.7	64	69	15.6	99	104	2.3
30	35	42.8	65	70	15.0	100	105	2.1
31	36	41.9	66	71	14.4	101	106	1.9
32	37	41.0	67	72	13.8	102	107	1.7
33	38	40.0	68	73	13.2	103	108	1.5
34	39	39.1	69	74	12.6	104	109	1.3
35	40	38.2	70	75	12.1	105	110	1.2
36	41	37.3	71	76	11.6	106	111	1.0
37	42	36.5	72	77	11.0	107	112	.8
38	43	35.6	73	78	10.5	108	113	.7
39	44	34.7	74	79	10.1	109	114	.6
40	45	33.8	75	80	9.6	110	115	.5
						111	116	0

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES

Ages																
	Male	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Male	Female	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	73.5	73.0	72.6	72.2	71.8	71.4	71.0	70.7	70.4	70.0	69.7	69.5	69.2	68.9	68.7
7	12	73.0	72.6	72.1	71.7	71.3	70.9	70.5	70.1	69.8	69.4	69.1	68.8	68.5	68.3	68.0
8	13	72.6	72.1	71.6	71.2	70.8	70.4	70.0	69.6	69.2	68.9	68.5	68.2	67.9	67.6	67.3
9	14	72.2	71.7	71.2	70.7	70.3	69.9	69.4	69.0	68.7	68.3	67.9	67.6	67.3	67.0	66.7
10	15	71.8	71.3	70.8	70.3	69.8	69.4	68.9	68.5	68.1	67.7	67.4	67.0	66.7	66.4	66.1
11	16	71.4	70.9	70.4	69.9	69.4	68.9	68.5	68.0	67.6	67.2	66.8	66.5	66.1	65.8	65.4
12	17	71.0	70.5	70.0	69.4	68.9	68.5	68.0	67.5	67.1	66.7	66.3	65.9	65.5	65.2	64.8
13	18	70.7	70.1	69.6	69.0	68.5	68.0	67.5	67.1	66.6	66.2	65.8	65.4	65.0	64.6	64.2
14	19	70.4	69.8	69.2	68.7	68.1	67.6	67.1	66.6	66.1	65.7	65.3	64.8	64.4	64.0	63.7
15	20	70.0	69.4	68.9	68.3	67.7	67.2	66.7	66.2	65.7	65.2	64.8	64.3	63.9	63.5	63.1
16	21	69.7	69.1	68.5	67.9	67.4	66.8	66.3	65.8	65.3	64.8	64.3	63.8	63.4	63.0	62.6
17	22	69.5	68.8	68.2	67.6	67.0	66.5	65.9	65.4	64.8	64.3	63.8	63.4	62.9	62.5	62.0
18	23	69.2	68.5	67.9	67.3	66.7	66.1	65.5	65.0	64.4	63.9	63.4	62.9	62.4	62.0	61.5
19	24	68.9	68.3	67.6	67.0	66.4	65.8	65.2	64.6	64.0	63.5	63.0	62.5	62.0	61.5	61.0
20	25	68.7	68.0	67.3	66.7	66.1	65.4	64.8	64.2	63.7	63.1	62.6	62.0	61.5	61.0	60.6

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages																
	Male	21	22	23	24	25	26	27	28	29	30	31	32	33	34	
Male	Female	26	27	28	29	30	31	32	33	34	35	36	37	38	39	
6	11	68.4	68.2	68.0	67.8	67.6	67.5	67.3	67.1	67.0	66.8	66.7	66.6	66.5	66.4	
7	12	67.8	67.5	67.3	67.1	66.9	66.7	66.5	66.4	66.2	66.1	65.9	65.8	65.7	65.6	
8	13	67.1	66.8	66.6	66.4	66.2	66.0	65.8	65.6	65.4	65.3	65.1	65.0	64.9	64.7	
9	14	66.4	66.2	65.9	65.7	65.4	65.2	65.0	64.8	64.7	64.5	64.3	64.2	64.1	63.9	
10	15	65.8	65.5	65.2	65.0	64.7	64.5	64.3	64.1	63.9	63.7	63.6	63.4	63.3	63.1	
11	16	65.1	64.8	64.6	64.3	64.1	63.8	63.6	63.4	63.2	63.0	62.8	62.6	62.5	62.3	
12	17	64.5	64.2	63.9	63.6	63.4	63.1	62.9	62.7	62.4	62.2	62.0	61.9	61.7	61.5	
13	18	63.9	63.6	63.3	63.0	62.7	62.4	62.2	61.9	61.7	61.5	61.3	61.1	60.9	60.8	
14	19	63.3	63.0	62.7	62.3	62.0	61.8	61.5	61.2	61.0	60.8	60.6	60.4	60.2	60.0	
15	20	62.7	62.4	62.0	61.7	61.4	61.1	60.8	60.6	60.3	60.1	59.8	59.6	59.4	59.2	
16	21	62.2	61.8	61.4	61.1	60.8	60.5	60.2	59.9	59.6	59.4	59.1	58.9	58.7	58.5	
17	22	61.6	61.2	60.9	60.5	60.2	59.8	59.5	59.2	58.9	58.7	58.4	58.2	57.9	57.7	
18	23	61.1	60.7	60.3	59.9	59.6	59.2	58.9	58.6	58.3	58.0	57.7	57.5	57.2	57.0	
19	24	60.6	60.2	59.7	59.4	59.0	58.6	58.3	57.9	57.6	57.3	57.0	56.8	56.5	56.3	
20	25	60.1	59.6	59.2	58.8	58.4	58.0	57.7	57.3	57.0	56.7	56.4	56.1	55.8	55.6	
21	26	59.6	59.1	58.7	58.3	57.9	57.5	57.1	56.7	56.4	56.0	55.7	55.4	55.1	54.9	
22	27	59.1	58.7	58.2	57.7	57.3	56.9	56.5	56.1	55.8	55.4	55.1	54.8	54.5	54.2	
23	28	58.7	58.2	57.7	57.2	56.8	56.4	55.9	55.5	55.2	54.8	54.4	54.1	53.8	53.5	
24	29	58.3	57.7	57.2	56.8	56.3	55.8	55.4	55.0	54.6	54.2	53.8	53.5	53.2	52.8	
25	30	57.9	57.3	56.8	56.3	55.8	55.3	54.9	54.4	54.0	53.6	53.2	52.9	52.5	52.2	
26	31	57.5	56.9	56.4	55.8	55.3	54.8	54.4	53.9	53.5	53.1	52.7	52.3	51.9	51.6	
27	32	57.1	56.5	55.9	55.4	54.9	54.4	53.9	53.4	53.0	52.5	52.1	51.7	51.3	50.9	
28	33	56.7	56.1	55.5	55.0	54.4	53.9	53.4	52.9	52.4	52.0	51.6	51.1	50.7	50.3	
29	34	56.4	55.8	55.2	54.6	54.0	53.5	53.0	52.4	52.0	51.5	51.0	50.6	50.2	49.8	
30	35	56.0	55.4	54.8	54.2	53.6	53.1	52.5	52.0	51.5	51.0	50.5	50.1	49.6	49.2	
31	36	55.7	55.1	54.4	53.8	53.2	52.7	52.1	51.6	51.0	50.5	50.0	49.5	49.1	48.7	
32	37	55.4	54.8	54.1	53.5	52.9	52.3	51.7	51.1	50.6	50.1	49.5	49.1	48.6	48.1	
33	38	55.1	54.5	53.8	53.2	52.5	51.9	51.3	50.7	50.2	49.6	49.1	48.6	48.1	47.6	
34	39	54.9	54.2	53.5	52.8	52.2	51.6	50.9	50.3	49.8	49.2	48.7	48.1	47.6	47.1	

Ages																
	Male	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
Male	Female	40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
6	11	66.3	66.2	66.1	66.0	65.9	65.9	65.8	65.7	65.7	65.6	65.6	65.5	65.5	65.5	65.4
7	12	65.4	65.3	65.3	65.2	65.1	65.0	64.9	64.9	64.8	64.8	64.7	64.7	64.6	64.6	64.5
8	13	64.6	64.5	64.4	64.3	64.2	64.2	64.1	64.0	64.0	63.9	63.8	63.8	63.7	63.7	63.7
9	14	63.8	63.7	63.6	63.5	63.4	63.3	63.2	63.2	63.1	63.0	63.0	62.9	62.9	62.8	62.8
10	15	63.0	62.9	62.8	62.7	62.6	62.5	62.4	62.3	62.2	62.2	62.1	62.0	62.0	61.9	61.9
11	16	62.2	62.1	61.9	61.8	61.7	61.6	61.5	61.4	61.4	61.3	61.2	61.2	61.1	61.0	61.0
12	17	61.4	61.3	61.1	61.0	60.9	60.8	60.7	60.6	60.5	60.4	60.4	60.3	60.2	60.2	60.1
13	18	60.6	60.5	60.3	60.2	60.1	60.0	59.9	59.8	59.7	59.6	59.5	59.4	59.4	59.3	59.2
14	19	59.8	59.7	59.5	59.4	59.3	59.1	59.0	58.9	58.8	58.7	58.6	58.6	58.5	58.4	58.4
15	20	59.0	58.9	58.7	58.6	58.4	58.3	58.2	58.1	58.0	57.9	57.8	57.7	57.6	57.6	57.5
16	21	58.3	58.1	57.9	57.8	57.6	57.5	57.4	57.2	57.1	57.0	56.9	56.8	56.8	56.7	56.6
17	22	57.5	57.3	57.2	57.0	56.8	56.7	56.6	56.4	56.3	56.2	56.1	56.0	55.9	55.8	55.7
18	23	56.8	56.6	56.4	56.2	56.0	55.9	55.7	55.6	55.5	55.4	55.2	55.1	55.1	55.0	54.9
19	24	56.0	55.8	55.6	55.4	55.3	55.1	54.9	54.8	54.7	54.5	54.4	54.3	54.2	54.1	54.0
20	25	55.3	55.1	54.9	54.7	54.5	54.3	54.1	54.0	53.8	53.7	53.6	53.5	53.4	53.3	53.2
21	26	54.6	54.4	54.1	53.9	53.7	53.5	53.4	53.2	53.0	52.9	52.8	52.6	52.5	52.4	52.3
22	27	53.9	53.6	53.4	53.2	53.0	52.8	52.6	52.4	52.2	52.1	51.9	51.8	51.7	51.6	51.5
23	28	53.2	52.9	52.7	52.5	52.2	52.0	51.8	51.6	51.5	51.3	51.1	51.0	50.9	50.7	50.6
24	29	52.5	52.3	52.0	51.7	51.5	51.3	51.1	50.9	50.7	50.5	50.3	50.2	50.0	49.9	49.8
25	30	51.9	51.6	51.3	51.0	50.8	50.5	50.3	50.1	49.9	49.7	49.6	49.4	49.2	49.1	49.0
26	31	51.2	50.9	50.6	50.3	50.1	49.8	49.6	49.4	49.2	49.0	48.8	48.6	48.4	48.3	48.1
27	32	50.6	50.3	50.0	49.7	49.4	49.1	48.9	48.6	48.4	48.2	48.0	47.8	47.6	47.5	47.3
28	33	50.0	49.6	49.3	49.0	48.7	48.4	48.2	47.9	47.7	47.5	47.2	47.1	46.9	46.7	46.5
29	34	49.4	49.0	48.7	48.3	48.0	47.7	47.5	47.2	47.0	46.7	46.5	46.3	46.1	45.9	45.7
30	35	48.8	48.4	48.1	47.7	47.4	47.1	46.8	46.5	46.2	46.0	45.8	45.5	45.3	45.2	45.0
31	36	48.2	47.8	47.5	47.1	46.8	46.4	46.1	45.8	45.6	45.3	45.0	44.8	44.6	44.4	44.2
32	37	47.7	47.3	46.9	46.5	46.1	45.8	45.5	45.2	44.9	44.6	44.3	44.1	43.9	43.7	43.4
33	38	47.2	46.7	46.3	45.9	45.5	45.2	44.8	44.5	44.2	43.9	43.7	43.4	43.2	42.9	42.7
34	39	46.7	46.2	45.8	45.4	45.0	44.6	44.2	43.9	43.6	43.3	43.0	42.7	42.5	42.2	42.0

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages															
Male	Male	50	51	52	53	54	55	56	57	58	59	60	61	62	63
	Female	55	56	57	58	59	60	61	62	63	64	65	66	67	68
6	11	65.4	65.4	65.3	65.3	65.3	65.3	65.3	65.2	65.2	65.2	65.2	65.2	65.2	65.2
7	12	64.5	64.5	64.4	64.4	64.4	64.4	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.2
8	13	63.6	63.6	63.5	63.5	63.5	63.5	63.4	63.4	63.4	63.4	63.4	63.4	63.3	63.3
9	14	62.7	62.7	62.7	62.6	62.6	62.6	62.5	62.5	62.5	62.5	62.5	62.4	62.4	62.4
10	15	61.8	61.8	61.8	61.7	61.7	61.7	61.6	61.6	61.6	61.6	61.6	61.5	61.5	61.5
11	16	61.0	60.9	60.9	60.8	60.8	60.8	60.7	60.7	60.7	60.7	60.6	60.6	60.6	60.6
12	17	60.1	60.0	60.0	59.9	59.9	59.9	59.8	59.8	59.8	59.8	59.7	59.7	59.7	59.7
13	18	59.2	59.1	59.1	59.0	59.0	59.0	58.9	58.9	58.9	58.9	58.8	58.8	58.8	58.8
14	19	58.3	58.2	58.2	58.2	58.1	58.1	58.0	58.0	58.0	57.9	57.9	57.9	57.9	57.9
15	20	57.4	57.4	57.3	57.3	57.2	57.2	57.1	57.1	57.1	57.0	57.0	57.0	57.0	56.9
16	21	56.5	56.5	56.4	56.4	56.3	56.3	56.2	56.2	56.2	56.1	56.1	56.1	56.1	56.0
17	22	55.7	55.6	55.5	55.5	55.4	55.4	55.3	55.3	55.3	55.2	55.2	55.2	55.1	55.1
18	23	54.8	54.7	54.7	54.6	54.6	54.5	54.4	54.4	54.4	54.3	54.3	54.3	54.2	54.2
19	24	53.9	53.9	53.8	53.7	53.7	53.6	53.6	53.5	53.5	53.4	53.4	53.4	53.3	53.3
20	25	53.1	53.0	52.9	52.8	52.8	52.7	52.7	52.6	52.6	52.5	52.5	52.4	52.4	52.4
21	26	52.2	52.1	52.0	52.0	51.9	51.8	51.8	51.7	51.7	51.6	51.6	51.5	51.5	51.5
22	27	51.4	51.3	51.2	51.1	51.0	51.0	50.9	50.8	50.8	50.7	50.7	50.6	50.6	50.6
23	28	50.5	50.4	50.3	50.2	50.2	50.1	50.0	50.0	49.9	49.8	49.8	49.7	49.7	49.7
24	29	49.7	49.6	49.5	49.4	49.3	49.2	49.1	49.1	49.0	49.0	48.9	48.9	48.8	48.8
25	30	48.8	48.7	48.6	48.5	48.4	48.3	48.3	48.2	48.1	48.1	48.0	48.0	47.9	47.9
26	31	48.0	47.9	47.8	47.7	47.6	47.5	47.4	47.3	47.3	47.2	47.1	47.1	47.0	47.0
27	32	47.2	47.1	46.9	46.8	46.7	46.6	46.5	46.5	46.4	46.3	46.2	46.2	46.1	46.1
28	33	46.4	46.3	46.1	46.0	45.9	45.8	45.7	45.6	45.5	45.4	45.4	45.3	45.2	45.2
29	34	45.6	45.4	45.3	45.2	45.1	44.9	44.8	44.7	44.7	44.6	44.5	44.4	44.4	44.3
30	35	44.8	44.6	44.5	44.4	44.2	44.1	44.0	43.9	43.8	43.7	43.6	43.6	43.5	43.4
31	36	44.0	43.9	43.7	43.6	43.4	43.3	43.2	43.1	43.0	42.9	42.8	42.7	42.6	42.6
32	37	43.3	43.1	42.9	42.8	42.6	42.5	42.4	42.2	42.1	42.0	41.9	41.9	41.8	41.7
33	38	42.5	42.3	42.1	42.0	41.8	41.7	41.5	41.4	41.3	41.2	41.1	41.0	40.9	40.8
34	39	41.8	41.6	41.4	41.2	41.0	40.9	40.7	40.6	40.5	40.4	40.3	40.2	40.1	40.0

Ages																
Male	Male	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
	Female	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1
7	12	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.1	64.1
8	13	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.4	62.4	62.4	62.4	62.4	62.4	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.5	61.5	61.5	61.5	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.6	60.6	60.6	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5
12	17	59.7	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.5	59.5	59.5
13	18	58.8	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.6	58.6	58.6	58.6	58.6
14	19	57.8	57.8	57.8	57.8	57.8	57.8	57.8	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.9	56.9	56.9	56.9	56.9	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8
16	21	56.0	56.0	56.0	56.0	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.8
17	22	55.1	55.1	55.1	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	54.9	54.9	54.9	54.9
18	23	54.2	54.2	54.1	54.1	54.1	54.1	54.1	54.1	54.0	54.0	54.0	54.0	54.0	54.0	54.0
19	24	53.3	53.2	53.2	53.2	53.2	53.2	53.2	53.1	53.1	53.1	53.1	53.1	53.1	53.1	53.1
20	25	52.4	52.3	52.3	52.3	52.3	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.1	52.1
21	26	51.4	51.4	51.4	51.4	51.3	51.3	51.3	51.3	51.3	51.3	51.3	51.2	51.2	51.2	51.2
22	27	50.5	50.5	50.5	50.5	50.4	50.4	50.4	50.4	50.4	50.3	50.3	50.3	50.3	50.3	50.3
23	28	49.6	49.6	49.6	49.5	49.5	49.5	49.5	49.5	49.4	49.4	49.4	49.4	49.4	49.4	49.4
24	29	48.7	48.7	48.7	48.6	48.6	48.6	48.6	48.5	48.5	48.5	48.5	48.5	48.4	48.4	48.4
25	30	47.8	47.8	47.8	47.7	47.7	47.7	47.6	47.6	47.6	47.6	47.6	47.5	47.5	47.5	47.5
26	31	46.9	46.9	46.8	46.8	46.8	46.8	46.7	46.7	46.7	46.7	46.6	46.6	46.6	46.6	46.6
27	32	46.0	46.0	45.9	45.9	45.9	45.8	45.8	45.8	45.8	45.7	45.7	45.7	45.7	45.7	45.7
28	33	45.1	45.1	45.1	45.0	45.0	44.9	44.9	44.9	44.9	44.8	44.8	44.8	44.8	44.8	44.8
29	34	44.3	44.2	44.2	44.1	44.1	44.0	44.0	44.0	44.0	43.9	43.9	43.9	43.9	43.9	43.8
30	35	43.4	43.3	43.3	43.2	43.2	43.1	43.1	43.1	43.1	43.1	43.0	43.0	43.0	42.9	42.9
31	36	42.5	42.4	42.4	42.3	42.3	42.3	42.2	42.2	42.2	42.2	42.1	42.1	42.1	42.0	42.0
32	37	41.6	41.6	41.5	41.5	41.4	41.4	41.3	41.3	41.3	41.2	41.2	41.2	41.2	41.1	41.1
33	38	40.8	40.7	40.7	40.6	40.5	40.5	40.4	40.4	40.3	40.3	40.3	40.3	40.2	40.2	40.2
34	39	39.9	39.9	39.8	39.7	39.7	39.6	39.6	39.5	39.5	39.5	39.4	39.4	39.4	39.3	39.3

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages															
Male	Male	79	80	81	82	83	84	85	86	87	88	89	90	91	92
	Female	84	85	86	87	88	89	90	91	92	93	94	95	96	97
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.5	60.5	60.5	60.5	60.5	60.5	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.8	56.8	56.8	56.8	56.8	56.8	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	53.9
19	24	53.1	53.1	53.1	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2
22	27	50.3	50.3	50.3	50.3	50.3	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.4	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4
25	30	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.6	46.6	46.6	46.6	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.7	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7
29	34	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.7	43.7	43.7	43.7	43.7
30	35	42.9	42.9	42.9	42.9	42.9	42.9	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	42.0	42.0	42.0	42.0	42.0	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.1	41.1	41.1	41.1	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.2	40.2	40.2	40.2	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1
34	39	39.3	39.3	39.3	39.3	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2

Ages																
Male	Male	93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
	Female	98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
6	11	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9
19	24	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1
22	27	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.3	48.3
25	30	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6
29	34	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7
30	35	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.0
34	39	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.1	39.1	39.1	39.1

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages														
Male	Male	35	36	37	38	39	40	41	42	43	44	45	46	47
Male	Female	40	41	42	43	44	45	46	47	48	49	50	51	52
35	40	46.2	45.7	45.3	44.8	44.4	44.0	43.6	43.3	43.0	42.6	42.3	42.0	41.8
36	41	45.7	45.2	44.8	44.3	43.9	43.5	43.1	42.7	42.3	42.0	41.7	41.4	41.1
37	42	45.3	44.8	44.3	43.8	43.4	42.9	42.5	42.1	41.8	41.4	41.1	40.7	40.4
38	43	44.8	44.3	43.8	43.3	42.9	42.4	42.0	41.6	41.2	40.8	40.5	40.1	39.8
39	44	44.4	43.9	43.4	42.9	42.4	41.9	41.5	41.0	40.6	40.2	39.9	39.5	39.2
40	45	44.0	43.5	42.9	42.4	41.9	41.4	41.0	40.5	40.1	39.7	39.3	38.9	38.6
41	46	43.6	43.1	42.5	42.0	41.5	41.0	40.5	40.0	39.6	39.2	38.8	38.4	38.0
42	47	43.3	42.7	42.1	41.6	41.0	40.5	40.0	39.6	39.1	38.7	38.2	37.8	37.5
43	48	43.0	42.3	41.8	41.2	40.6	40.1	39.6	39.1	38.6	38.2	37.7	37.3	36.9
44	49	42.6	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.2	37.7	37.2	36.8	36.4
45	50	42.3	41.7	41.1	40.5	39.9	39.3	38.8	38.2	37.7	37.2	36.8	36.3	35.9
46	51	42.0	41.4	40.7	40.1	39.5	38.9	38.4	37.8	37.3	36.8	36.3	35.9	35.4
47	52	41.8	41.1	40.4	39.8	39.2	38.6	38.0	37.5	36.9	36.4	35.9	35.4	35.0

Ages														
Male	Male	48	49	50	51	52	53	54	55	56	57	58	59	60
Male	Female	53	54	55	56	57	58	59	60	61	62	63	64	65
35	40	41.5	41.3	41.0	40.8	40.6	40.4	40.3	40.1	40.0	39.8	39.7	39.6	39.5
36	41	40.8	40.6	40.3	40.1	39.9	39.7	39.5	39.3	39.2	39.0	38.9	38.8	38.6
37	42	40.2	39.9	39.6	39.4	39.2	39.0	38.8	38.6	38.4	38.3	38.1	38.0	37.9
38	43	39.5	39.2	39.0	38.7	38.5	38.3	38.1	37.9	37.7	37.5	37.3	37.2	37.1
39	44	38.9	38.6	38.3	38.0	37.8	37.6	37.3	37.1	36.9	36.8	36.6	36.4	36.3
40	45	38.3	38.0	37.7	37.4	37.1	36.9	36.6	36.4	36.2	36.0	35.9	35.7	35.5
41	46	37.7	37.3	37.0	36.7	36.5	36.2	36.0	35.7	35.5	35.3	35.1	35.0	34.8
42	47	37.1	36.8	36.4	36.1	35.8	35.6	35.3	35.1	34.8	34.6	34.4	34.2	34.1
43	48	36.5	36.2	35.8	35.5	35.2	34.9	34.7	34.4	34.2	33.9	33.7	33.5	33.3
44	49	36.0	35.6	35.3	34.9	34.6	34.3	34.0	33.8	33.5	33.3	33.0	32.8	32.6
45	50	35.5	35.1	34.7	34.4	34.0	33.7	33.4	33.1	32.9	32.6	32.4	32.2	31.9
46	51	35.0	34.6	34.2	33.8	33.5	33.1	32.8	32.5	32.2	32.0	31.7	31.5	31.3
47	52	34.5	34.1	33.7	33.3	32.9	32.6	32.2	31.9	31.6	31.4	31.1	30.9	30.6
48	53	34.0	33.6	33.2	32.8	32.4	32.0	31.7	31.4	31.1	30.8	30.5	30.2	30.0
49	54	33.6	33.1	32.7	32.3	31.9	31.5	31.2	30.8	30.5	30.2	29.9	29.6	29.4
50	55	33.2	32.7	32.3	31.8	31.4	31.0	30.6	30.3	29.9	29.6	29.3	29.0	28.8
51	56	32.8	32.3	31.8	31.4	30.9	30.5	30.1	29.8	29.4	29.1	28.8	28.5	28.2
52	57	32.4	31.9	31.4	30.9	30.5	30.1	29.7	29.3	28.9	28.6	28.2	27.9	27.6
53	58	32.0	31.5	31.0	30.5	30.1	29.6	29.2	28.8	28.4	28.1	27.7	27.4	27.1
54	59	31.7	31.2	30.6	30.1	29.7	29.2	28.8	28.3	27.9	27.6	27.2	26.9	26.5
55	60	31.4	30.8	30.3	29.8	29.3	28.8	28.3	27.9	27.5	27.1	26.7	26.4	26.0
56	61	31.1	30.5	29.9	29.4	28.9	28.4	27.9	27.5	27.1	26.7	26.3	25.9	25.5
57	62	30.8	30.2	29.6	29.1	28.6	28.1	27.6	27.1	26.7	26.2	25.8	25.4	25.1
58	63	30.5	29.9	29.3	28.8	28.2	27.7	27.2	26.7	26.3	25.8	25.4	25.0	24.6
59	64	30.2	29.6	29.0	28.5	27.9	27.4	26.9	26.4	25.9	25.4	25.0	24.6	24.2
60	65	30.0	29.4	28.8	28.2	27.6	27.1	26.5	26.0	25.5	25.1	24.6	24.2	23.8

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages														
Male	Male	61	62	63	64	65	66	67	68	69	70	71	72	73
Male	Female	66	67	68	69	70	71	72	73	74	75	76	77	78
35	40	39.4	39.3	39.2	39.1	39.0	38.9	38.9	38.8	38.8	38.7	38.7	38.6	38.6
36	41	38.5	38.4	38.3	38.2	38.2	38.1	38.0	38.0	37.9	37.9	37.8	37.8	37.7
37	42	37.7	37.6	37.5	37.4	37.3	37.3	37.2	37.1	37.1	37.0	36.9	36.9	36.9
38	43	36.9	36.8	36.7	36.6	36.5	36.4	36.4	36.3	36.2	36.2	36.1	36.0	36.0
39	44	36.2	36.0	35.9	35.8	35.7	35.6	35.5	35.5	35.4	35.3	35.3	35.2	35.2
40	45	35.4	35.3	35.1	35.0	34.9	34.8	34.7	34.6	34.6	34.5	34.4	34.4	34.3
41	46	34.6	34.5	34.4	34.2	34.1	34.0	33.9	33.8	33.8	33.7	33.6	33.5	33.5
42	47	33.9	33.7	33.6	33.5	33.4	33.2	33.1	33.0	33.0	32.9	32.8	32.7	32.7
43	48	33.2	33.0	32.9	32.7	32.6	32.5	32.4	32.3	32.2	32.1	32.0	31.9	31.9
44	49	32.5	32.3	32.1	32.0	31.8	31.7	31.6	31.5	31.4	31.3	31.2	31.1	31.1
45	50	31.8	31.6	31.4	31.3	31.1	31.0	30.8	30.7	30.6	30.5	30.4	30.4	30.3
46	51	31.1	30.9	30.7	30.5	30.4	30.2	30.1	30.0	29.9	29.8	29.7	29.6	29.5
47	52	30.4	30.2	30.0	29.8	29.7	29.5	29.4	29.3	29.1	29.0	28.9	28.8	28.7
48	53	29.8	29.5	29.3	29.2	29.0	28.8	28.7	28.5	28.4	28.3	28.2	28.1	28.0
49	54	29.1	28.9	28.7	28.5	28.3	28.1	28.0	27.8	27.7	27.6	27.5	27.4	27.3
50	55	28.5	28.3	28.1	27.8	27.6	27.5	27.3	27.1	27.0	26.9	26.7	26.6	26.5
51	56	27.9	27.7	27.4	27.2	27.0	26.8	26.6	26.5	26.3	26.2	26.0	25.9	25.8
52	57	27.3	27.1	26.8	26.6	26.4	26.2	26.0	25.8	25.7	25.5	25.4	25.2	25.1
53	58	26.8	26.5	26.2	26.0	25.8	25.6	25.4	25.2	25.0	24.8	24.7	24.6	24.4
54	59	26.2	25.9	25.7	25.4	25.2	25.0	24.7	24.6	24.4	24.2	24.0	23.9	23.8
55	60	25.7	25.4	25.1	24.9	24.6	24.4	24.1	23.9	23.8	23.6	23.4	23.3	23.1
56	61	25.2	24.9	24.6	24.3	24.1	23.8	23.6	23.4	23.2	23.0	22.8	22.6	22.5
57	62	24.7	24.4	24.1	23.8	23.5	23.3	23.0	22.8	22.6	22.4	22.2	22.0	21.9
58	63	24.3	23.9	23.6	23.3	23.0	22.7	22.5	22.2	22.0	21.8	21.6	21.4	21.3
59	64	23.8	23.5	23.1	22.8	22.5	22.2	21.9	21.7	21.5	21.2	21.0	20.9	20.7
60	65	23.4	23.0	22.7	22.3	22.0	21.7	21.4	21.2	20.9	20.7	20.5	20.3	20.1
61	66	23.0	22.6	22.2	21.9	21.6	21.3	21.0	20.7	20.4	20.2	20.0	19.8	19.6
62	67	22.6	22.2	21.8	21.5	21.1	20.8	20.5	20.2	19.9	19.7	19.5	19.2	19.0
63	68	22.2	21.8	21.4	21.1	20.7	20.4	20.1	19.8	19.5	19.2	19.0	18.7	18.5
64	69	21.9	21.5	21.1	20.7	20.3	20.0	19.6	19.3	19.0	18.7	18.5	18.2	18.0
65	70	21.6	21.1	20.7	20.3	19.9	19.6	19.2	18.9	18.6	18.3	18.0	17.8	17.5
66	71	21.3	20.8	20.4	20.0	19.6	19.2	18.8	18.5	18.2	17.9	17.6	17.3	17.1
67	72	21.0	20.5	20.1	19.6	19.2	18.8	18.5	18.1	17.8	17.5	17.2	16.9	16.7
68	73	20.7	20.2	19.8	19.3	18.9	18.5	18.1	17.8	17.4	17.1	16.8	16.5	16.2
69	74	20.4	19.9	19.5	19.0	18.6	18.2	17.8	17.4	17.1	16.7	16.4	16.1	15.8
70	75	20.2	19.7	19.2	18.7	18.3	17.9	17.5	17.1	16.7	16.4	16.1	15.8	15.5
71	76	20.0	19.5	19.0	18.5	18.0	17.6	17.2	16.8	16.4	16.1	15.7	15.4	15.1
72	77	19.8	19.2	18.7	18.2	17.8	17.3	16.9	16.5	16.1	15.8	15.4	15.1	14.8
73	78	19.6	19.0	18.5	18.0	17.5	17.1	16.7	16.2	15.8	15.5	15.1	14.8	14.4

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages													
	Male	74	75	76	77	78	79	80	81	82	83	84	85
Male	Female	79	80	81	82	83	84	85	86	87	88	89	90
35	40	38.6	38.5	38.5	38.5	38.4	38.4	38.4	38.4	38.4	38.4	38.3	38.3
36	41	37.7	37.6	37.6	37.6	37.6	37.5	37.5	37.5	37.5	37.5	37.5	37.4
37	42	36.8	36.8	36.7	36.7	36.7	36.7	36.6	36.6	36.6	36.6	36.6	36.6
38	43	36.0	35.9	35.9	35.9	35.8	35.8	35.8	35.8	35.7	35.7	35.7	35.7
39	44	35.1	35.1	35.0	35.0	35.0	34.9	34.9	34.9	34.9	34.8	34.8	34.8
40	45	34.3	34.2	34.2	34.1	34.1	34.1	34.1	34.0	34.0	34.0	34.0	34.0
41	46	33.4	33.4	33.3	33.3	33.3	33.2	33.2	33.2	33.2	33.1	33.1	33.1
42	47	32.6	32.6	32.5	32.5	32.4	32.4	32.4	32.3	32.3	32.3	32.3	32.3
43	48	31.8	31.8	31.7	31.7	31.6	31.6	31.5	31.5	31.5	31.5	31.4	31.4
44	49	31.0	30.9	30.9	30.8	30.8	30.8	30.7	30.7	30.7	30.6	30.6	30.6
45	50	30.2	30.1	30.1	30.0	30.0	29.9	29.9	29.9	29.8	29.8	29.8	29.8
46	51	29.4	29.4	29.3	29.2	29.2	29.2	29.1	29.1	29.0	29.0	29.0	28.9
47	52	28.7	28.6	28.5	28.5	28.4	28.4	28.3	28.3	28.2	28.2	28.2	28.1
48	53	27.9	27.8	27.8	27.7	27.6	27.6	27.5	27.5	27.5	27.4	27.4	27.4
49	54	27.2	27.1	27.0	26.9	26.9	26.8	26.8	26.7	26.7	26.6	26.6	26.6
50	55	26.4	26.3	26.3	26.2	26.1	26.1	26.0	26.0	25.9	25.9	25.8	25.8
51	56	25.7	25.6	25.5	25.5	25.4	25.3	25.3	25.2	25.2	25.1	25.1	25.0
52	57	25.0	24.9	24.8	24.7	24.7	24.6	24.5	24.5	24.4	24.4	24.3	24.3
53	58	24.3	24.2	24.1	24.0	23.9	23.9	23.8	23.7	23.7	23.6	23.6	23.5
54	59	23.6	23.5	23.4	23.3	23.2	23.2	23.1	23.0	23.0	22.9	22.9	22.8
55	60	23.0	22.9	22.8	22.7	22.6	22.5	22.4	22.3	22.3	22.2	22.2	22.1
56	61	22.3	22.2	22.1	22.0	21.9	21.8	21.7	21.6	21.6	21.5	21.5	21.4
57	62	21.7	21.6	21.5	21.3	21.2	21.1	21.1	21.0	20.9	20.8	20.8	20.7
58	63	21.1	21.0	20.8	20.7	20.6	20.5	20.4	20.3	20.2	20.2	20.1	20.0
59	64	20.5	20.4	20.2	20.1	20.0	19.9	19.8	19.7	19.6	19.5	19.4	19.4
60	65	19.9	19.8	19.6	19.5	19.4	19.3	19.1	19.0	19.0	18.9	18.8	18.7
61	66	19.4	19.2	19.1	18.9	18.8	18.7	18.5	18.4	18.3	18.3	18.2	18.1
62	67	18.8	18.7	18.5	18.3	18.2	18.1	18.0	17.8	17.7	17.7	17.6	17.5
63	68	18.3	18.1	18.0	17.8	17.6	17.5	17.4	17.3	17.2	17.1	17.0	16.9
64	69	17.8	17.6	17.4	17.3	17.1	17.0	16.8	16.7	16.6	16.5	16.4	16.3
65	70	17.3	17.1	16.9	16.7	16.6	16.4	16.3	16.2	16.0	15.9	15.8	15.8
66	71	16.9	16.6	16.4	16.3	16.1	15.9	15.8	15.6	15.5	15.4	15.3	15.2
67	72	16.4	16.2	16.0	15.8	15.6	15.4	15.3	15.1	15.0	14.9	14.8	14.7
68	73	16.0	15.7	15.5	15.3	15.1	15.0	14.8	14.6	14.5	14.4	14.3	14.2
69	74	15.6	15.3	15.1	14.9	14.7	14.5	14.3	14.2	14.0	13.9	13.8	13.7
70	75	15.2	14.9	14.7	14.5	14.3	14.1	13.9	13.7	13.6	13.4	13.3	13.2
71	76	14.8	14.5	14.3	14.1	13.8	13.6	13.5	13.3	13.1	13.0	12.8	12.7
72	77	14.5	14.2	13.9	13.7	13.5	13.2	13.0	12.9	12.7	12.5	12.4	12.3
73	78	14.1	13.8	13.6	13.3	13.1	12.9	12.7	12.5	12.3	12.1	12.0	11.8
74	79	13.8	13.5	13.2	13.0	12.7	12.5	12.3	12.1	11.9	11.7	11.6	11.4
75	80	13.5	13.2	12.9	12.6	12.4	12.2	11.9	11.7	11.5	11.4	11.2	11.0
76	81	13.2	12.9	12.6	12.3	12.1	11.8	11.6	11.4	11.2	11.0	10.8	10.7
77	82	13.0	12.6	12.3	12.1	11.8	11.5	11.3	11.1	10.8	10.7	10.5	10.3
78	83	12.7	12.4	12.1	11.8	11.5	11.2	11.0	10.7	10.5	10.3	10.1	10.0
79	84	12.5	12.2	11.8	11.5	11.2	11.0	10.7	10.5	10.2	10.0	9.8	9.6
80	85	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.2	10.0	9.7	9.5	9.3
81	86	12.1	11.7	11.4	11.1	10.7	10.5	10.2	9.9	9.7	9.5	9.3	9.1
82	87	11.9	11.5	11.2	10.8	10.5	10.2	10.0	9.7	9.4	9.2	9.0	8.8
83	88	11.7	11.4	11.0	10.7	10.3	10.0	9.7	9.5	9.2	9.0	8.7	8.5
84	89	11.6	11.2	10.8	10.5	10.1	9.8	9.5	9.3	9.0	8.7	8.5	8.3
85	90	11.4	11.0	10.7	10.3	10.0	9.6	9.3	9.1	8.8	8.5	8.3	8.1

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages													
	Male	86	87	88	89	90	91	92	93	94	95	96	97
Male	Female	91	92	93	94	95	96	97	98	99	100	101	102
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5
38	43	35.7	35.7	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6
39	44	34.8	34.8	34.8	34.8	34.8	34.8	34.7	34.7	34.7	34.7	34.7	34.7
40	45	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9
41	46	33.1	33.1	33.1	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
42	47	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.1	32.1	32.1
43	48	31.4	31.4	31.4	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3
44	49	30.6	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.4
45	50	29.7	29.7	29.7	29.7	29.7	29.7	29.7	29.6	29.6	29.6	29.6	29.6
46	51	28.9	28.9	28.9	28.9	28.9	28.8	28.8	28.8	28.8	28.8	28.8	28.8
47	52	28.1	28.1	28.1	28.1	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
48	53	27.3	27.3	27.3	27.3	27.2	27.2	27.2	27.2	27.2	27.2	27.2	27.2
49	54	26.5	26.5	26.5	26.5	26.5	26.4	26.4	26.4	26.4	26.4	26.4	26.4
50	55	25.8	25.7	25.7	25.7	25.7	25.7	25.6	25.6	25.6	25.6	25.6	25.6
51	56	25.0	25.0	24.9	24.9	24.9	24.9	24.9	24.9	24.8	24.8	24.8	24.8
52	57	24.3	24.2	24.2	24.2	24.1	24.1	24.1	24.1	24.1	24.1	24.1	24.0
53	58	23.5	23.5	23.4	23.4	23.4	23.4	23.4	23.3	23.3	23.3	23.3	23.3
54	59	22.8	22.7	22.7	22.7	22.7	22.6	22.6	22.6	22.6	22.6	22.6	22.5
55	60	22.1	22.0	22.0	22.0	21.9	21.9	21.9	21.9	21.8	21.8	21.8	21.8
56	61	21.4	21.3	21.3	21.3	21.2	21.2	21.2	21.1	21.1	21.1	21.1	21.1
57	62	20.7	20.6	20.6	20.6	20.5	20.5	20.5	20.4	20.4	20.4	20.4	20.4
58	63	20.0	19.9	19.9	19.9	19.8	19.8	19.8	19.8	19.7	19.7	19.7	19.7
59	64	19.3	19.3	19.2	19.2	19.2	19.1	19.1	19.1	19.0	19.0	19.0	19.0

Ages													
	Male	98	99	100	101	102	103	104	105	106	107	108	
Male	Female	103	104	105	106	107	108	109	110	111	112	113	
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.2	38.2	38.2	38.2	38.2	
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.3	
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	
38	43	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	
39	44	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	
40	45	33.9	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	
41	46	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	
42	47	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	
43	48	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	
44	49	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	
45	50	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	
46	51	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.7	
47	52	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.9	27.9	27.9	27.9	
48	53	27.2	27.2	27.2	27.2	27.2	27.1	27.1	27.1	27.1	27.1	27.1	
49	54	26.4	26.4	26.4	26.4	26.4	26.3	26.3	26.3	26.3	26.3	26.3	
50	55	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.5	25.5	25.5	
51	56	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.7	
52	57	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	
53	58	23.3	23.3	23.3	23.3	23.3	23.3	23.2	23.2	23.2	23.2	23.2	
54	59	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	
55	60	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.7	21.7	
56	61	21.1	21.1	21.1	21.1	21.1	21.0	21.0	21.0	21.0	21.0	21.0	
57	62	20.4	20.4	20.4	20.3	20.3	20.3	20.3	20.3	20.3	20.3	20.3	
58	63	19.7	19.7	19.7	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6	
59	64	19.0	19.0	19.0	19.0	19.0	18.9	18.9	18.9	18.9	18.9	18.9	

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages													
	Male	86	87	88	89	90	91	92	93	94	95	96	97
Male	Female	91	92	93	94	95	96	97	98	99	100	101	102
60	65	18.7	18.6	18.6	18.5	18.5	18.5	18.4	18.4	18.4	18.4	18.3	18.3
61	66	18.1	18.0	17.9	17.9	17.9	17.8	17.8	17.8	17.7	17.7	17.7	17.7
62	67	17.4	17.4	17.3	17.3	17.2	17.2	17.1	17.1	17.1	17.1	17.0	17.0
63	68	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.5	16.5	16.4	16.4	16.4
64	69	16.2	16.2	16.1	16.1	16.0	16.0	15.9	15.9	15.9	15.8	15.8	15.8
65	70	15.7	15.6	15.5	15.5	15.4	15.4	15.3	15.3	15.3	15.2	15.2	15.2
66	71	15.1	15.0	15.0	14.9	14.8	14.8	14.7	14.7	14.7	14.6	14.6	14.6
67	72	14.6	14.5	14.4	14.4	14.3	14.2	14.2	14.1	14.1	14.1	14.1	14.0
68	73	14.1	14.0	13.9	13.8	13.8	13.7	13.6	13.6	13.6	13.5	13.5	13.5
69	74	13.6	13.5	13.4	13.3	13.2	13.2	13.1	13.1	13.0	13.0	13.0	12.9
70	75	13.1	13.0	12.9	12.8	12.7	12.7	12.6	12.5	12.5	12.5	12.4	12.4
71	76	12.6	12.5	12.4	12.3	12.2	12.2	12.1	12.1	12.0	12.0	11.9	11.9
72	77	12.1	12.0	11.9	11.8	11.8	11.7	11.6	11.6	11.5	11.5	11.4	11.4
73	78	11.7	11.6	11.5	11.4	11.3	11.2	11.2	11.1	11.0	11.0	11.0	10.9
74	79	11.3	11.2	11.1	11.0	10.9	10.8	10.7	10.7	10.6	10.6	10.5	10.5
75	80	10.9	10.8	10.7	10.5	10.5	10.4	10.3	10.2	10.2	10.1	10.1	10.0
76	81	10.5	10.4	10.3	10.2	10.1	10.0	9.9	9.8	9.7	9.7	9.7	9.6
77	82	10.2	10.0	9.9	9.8	9.7	9.6	9.5	9.4	9.3	9.3	9.2	9.2
78	83	9.8	9.7	9.5	9.4	9.3	9.2	9.1	9.0	9.0	8.9	8.9	8.8
79	84	9.5	9.3	9.2	9.1	8.9	8.8	8.8	8.7	8.6	8.5	8.5	8.4
80	85	9.2	9.0	8.9	8.7	8.6	8.5	8.4	8.3	8.3	8.2	8.1	8.1
81	86	8.9	8.7	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.9	7.8	7.7
82	87	8.6	8.4	8.3	8.1	8.0	7.9	7.8	7.7	7.6	7.5	7.5	7.4
83	88	8.3	8.2	8.0	7.9	7.7	7.6	7.5	7.4	7.3	7.2	7.2	7.1
84	89	8.1	7.9	7.8	7.6	7.5	7.3	7.2	7.1	7.0	7.0	6.9	6.8

Ages													
	Male	98	99	100	101	102	103	104	105	106	107	108
Male	Female	103	104	105	106	107	108	109	110	111	112	113
60	65	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.2	18.2	18.2	18.2
61	66	17.7	17.7	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.5
62	67	17.0	17.0	17.0	17.0	17.0	17.0	16.9	16.9	16.9	16.9	16.9
63	68	16.4	16.4	16.4	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.2
64	69	15.8	15.8	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.6
65	70	15.2	15.2	15.1	15.1	15.1	15.1	15.1	15.1	15.1	15.0	15.0
66	71	14.6	14.6	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.4	14.4
67	72	14.0	14.0	14.0	14.0	13.9	13.9	13.9	13.9	13.9	13.9	13.8
68	73	13.5	13.4	13.4	13.4	13.4	13.4	13.3	13.3	13.3	13.3	13.2
69	74	12.9	12.9	12.9	12.8	12.8	12.8	12.8	12.8	12.8	12.8	12.7
70	75	12.4	12.4	12.3	12.3	12.3	12.3	12.3	12.2	12.2	12.2	12.1
71	76	11.9	11.9	11.8	11.8	11.8	11.8	11.7	11.7	11.7	11.7	11.6
72	77	11.4	11.4	11.3	11.3	11.3	11.3	11.2	11.2	11.2	11.2	11.1
73	78	10.9	10.9	10.9	10.8	10.8	10.8	10.7	10.7	10.7	10.7	10.6
74	79	10.5	10.4	10.4	10.4	10.3	10.3	10.3	10.3	10.2	10.2	10.1
75	80	10.0	10.0	9.9	9.9	9.9	9.8	9.8	9.8	9.8	9.7	----
76	81	9.6	9.5	9.5	9.5	9.4	9.4	9.4	9.4	9.3	9.3	----
77	82	9.2	9.1	9.1	9.1	9.0	9.0	9.0	8.9	8.9	8.9	----
78	83	8.8	8.7	8.7	8.7	8.6	8.6	8.5	8.5	8.5	8.4	----
79	84	8.4	8.4	8.3	8.3	8.2	8.2	8.2	8.1	8.1	8.0	----
80	85	8.0	8.0	7.9	7.9	7.9	7.8	7.8	7.7	7.7	7.6	----
81	86	7.7	7.6	7.6	7.6	7.5	7.5	7.4	7.4	7.3	7.3	----
82	87	7.4	7.3	7.3	7.2	7.2	7.1	7.1	7.0	7.0	6.9	----
83	88	7.1	7.0	6.9	6.9	6.8	6.8	6.7	6.7	6.7	6.6	----
84	89	6.8	6.7	6.6	6.6	6.5	6.5	6.4	6.4	6.3	----	----

TABLE II—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages												
	Male	86	87	88	89	90	91	92	93	94	95	96
Male	Female	91	92	93	94	95	96	97	98	99	100	101
85	90	7.9	7.7	7.5	7.4	7.2	7.1	7.0	6.9	6.8	6.7	6.6
86	91	7.7	7.5	7.3	7.1	7.0	6.8	6.7	6.6	6.5	6.4	6.4
87	92	7.5	7.3	7.1	6.9	6.8	6.6	6.5	6.4	6.3	6.2	6.1
88	93	7.3	7.1	6.9	6.7	6.6	6.4	6.3	6.2	6.1	6.0	5.9
89	94	7.1	6.9	6.7	6.5	6.4	6.2	6.1	6.0	5.9	5.8	5.7
90	95	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6	5.5
91	96	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.5	5.4	5.3
92	97	6.7	6.5	6.3	6.1	5.9	5.8	5.6	5.5	5.4	5.3	5.2
93	98	6.6	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2	5.1	5.0
94	99	6.5	6.3	6.1	5.9	5.7	5.5	5.4	5.2	5.1	5.0	4.9
95	100	6.4	6.2	6.0	5.8	5.6	5.4	5.3	5.1	5.0	4.9	4.7
96	101	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9	4.7	4.6
97	102	6.3	6.1	5.8	5.6	5.4	5.2	5.1	4.9	4.8	4.6	4.5
98	103	6.2	6.0	5.8	5.5	5.3	5.1	5.0	4.8	4.7	4.5	4.4
99	104	6.2	5.9	5.7	5.5	5.2	5.1	4.9	4.7	4.6	4.4	4.3

Ages											
	Male	97	98	99	100	101	102	103	104	105	106
Male	Female	102	103	104	105	106	107	108	109	110	111
85	90	6.6	6.5	6.4	6.4	6.3	6.2	6.2	6.1	6.1	6.0
86	91	6.3	6.2	6.2	6.1	6.0	6.0	5.9	5.9	5.8	5.7
87	92	6.1	6.0	5.9	5.8	5.8	5.7	5.6	5.6	5.5	5.4
88	93	5.8	5.8	5.7	5.6	5.5	5.5	5.4	5.3	5.3	5.1
89	94	5.6	5.5	5.5	5.4	5.3	5.2	5.2	5.1	5.0	----
90	95	5.4	5.3	5.2	5.2	5.1	5.0	4.9	4.9	4.8	----
91	96	5.2	5.1	5.1	5.0	4.9	4.8	4.7	4.6	4.5	----
92	97	5.1	5.0	4.9	4.8	4.7	4.6	4.5	4.4	----	----
93	98	4.9	4.8	4.7	4.6	4.5	4.4	4.3	4.2	----	----
94	99	4.8	4.7	4.6	4.5	4.4	4.3	4.1	----	----	----
95	100	4.6	4.5	4.4	4.3	4.2	4.1	4.0	----	----	----
96	101	4.5	4.4	4.3	4.2	4.1	3.9	----	----	----	----
97	102	4.4	4.3	4.1	4.0	3.9	3.7	----	----	----	----
98	103	4.3	4.1	4.0	3.9	3.7	----	----	----	----	----
99	104	4.1	4.0	3.9	3.7	----	----	----	----	----	----

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES

Ages																	
	Male	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Male	Female	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	56.6	56.1	55.7	55.1	54.6	54.1	53.5	52.9	52.3	51.7	51.1	50.5	49.8	49.1	48.4
7	12	56.1	55.7	55.2	54.7	54.2	53.7	53.1	52.6	52.0	51.4	50.8	50.2	49.5	48.9	48.2
8	13	55.7	55.2	54.8	54.3	53.8	53.3	52.8	52.2	51.6	51.1	50.5	49.9	49.2	48.6	47.9
9	14	55.1	54.7	54.3	53.8	53.3	52.9	52.3	51.8	51.3	50.7	50.1	49.5	48.9	48.3	47.7
10	15	54.6	54.2	53.8	53.3	52.9	52.4	51.9	51.4	50.9	50.3	49.8	49.2	48.6	48.0	47.4
11	16	54.1	53.7	53.3	52.9	52.4	52.0	51 5	51.0	50.5	50.0	49.4	48.8	48.3	47.7	47.1
12	17	53.5	53.1	52.8	52.3	51.9	51.5	51.0	50.6	50.1	49.6	49.0	48.5	47.9	47.3	46.7
13	18	52.9	52 6	52.2	51.8	51.4	51.0	50.6	50.1	49.6	49.1	48.6	48.1	47.5	47.0	46.4
14	19	52.3	52.0	51.6	51.3	50.9	50.5	50.1	49.6	49.2	48.7	48.2	47.7	47.2	46.6	46.1
15	20	51.7	51.4	51.1	50.7	50.3	50.0	49.6	49.1	48.7	48.2	47.8	47.3	46.8	46.2	45.7
16	21	51.1	50.8	50.5	50.1	49.8	49.4	49.0	48.6	48.2	47.8	47.3	46.8	46.3	45.8	45.3
17	22	50.5	50.2	49.9	49.5	49.2	48.8	48.5	48.1	47.7	47.3	46.8	46.4	45.9	45.4	44.9
18	23	49.8	49.5	49.2	48.9	48.6	48.3	47.9	47.5	47.2	46.8	46.3	45.9	45.4	45.0	44.5
19	24	49.1	48.9	48.6	48.3	48.0	47.7	47.3	47.0	46.6	46.2	45.8	45.4	45.0	44.5	44.0
20	25	48.4	48.2	47.9	47.7	47.4	47.1	46.7	46.4	46.1	45.7	45.3	44.9	44.5	44.0	43.6

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages															
Male	21	22	23	24	25	26	27	28	29	30	31	32	33	34
Female	26	27	28	29	30	31	32	33	34	35	36	37	38	39
6	11	47.7	47.0	46.3	45.6	44.8	44.1	43.3	42.5	41.8	41.0	40.2	39.4	38.6	37.8
7	12	47.5	46.8	46.1	45.4	44.6	43.9	43.2	42.4	41.6	40.9	40.1	39.3	38.5	37.7
8	13	47.3	46.6	45.9	45.2	44.5	43.7	43.0	42.2	41.5	40.7	39.9	39.2	38.4	37.6
9	14	47.0	46.3	45.6	45.0	44.2	43.5	42.8	42.1	41.3	40.6	39.8	39.0	38.3	37.5
10	15	46.7	46.1	45.4	44.7	44.0	43.3	42.6	41.9	41.1	40.4	39.7	38.9	38.1	37.4
11	16	46.4	45.8	45.1	44.5	43.8	43.1	42.4	41.7	41.0	40.2	39.5	38.8	38.0	37.2
12	17	46.1	45.5	44.9	44.2	43.6	42.9	42.2	41.5	40.8	40.1	39.3	38.6	37.9	37.1
13	18	45.8	45.2	44.6	43.9	43.3	42.6	42.0	41.3	40.6	39.9	39.3	38.4	37.7	37.0
14	19	45.5	44.9	44.3	43.7	43.0	42.4	41.7	41.0	40.4	39.7	39.0	38.3	37.5	36.8
15	20	45.1	44.6	44.0	43.4	42.7	42.1	41.5	40.8	40.1	39.5	38.8	38.1	37.4	36.6
16	21	44.8	44.2	43.6	43.0	42.4	41.8	41.2	40.5	39.9	39.2	38.6	37.9	37.2	36.5
17	22	44.4	43.8	43.3	42.7	42.1	41.5	40.9	40.3	39.6	39.0	38.3	37.7	37.0	36.3
18	23	44.0	43.5	42.9	42.4	41.8	41.2	40.6	40.0	39.4	38.7	38.1	37.4	36.8	36.1
19	24	43.6	43.1	42.5	42.0	41.4	40.9	40.3	39.7	39.1	38.5	37.8	37.2	36.5	35.9
20	25	43.1	42.6	42.1	41.6	41.1	40.5	40.0	39.4	38.8	38.2	37.6	36.9	36.3	35.7
21	26	42.7	42.2	41.7	41.2	40.7	40.2	39.6	39.1	38.5	37.9	37.3	36.7	36.1	35.4
22	27	42.2	41.8	41.3	40.8	40.3	39.8	39.3	38.7	38.2	37.6	37.0	36.4	35.8	35.2
23	28	41.7	41.3	40.8	40.4	39.9	39.4	38.9	38.4	37.8	37.3	36.7	36.1	35.5	34.9
24	29	41.2	40.8	40.4	39.9	39.5	39.0	38.5	38.0	37.5	36.9	36.4	35.8	35.2	34.6
25	30	40.7	40.3	39.9	39.5	39.0	38.6	38.1	37.6	37.1	36.6	36.0	35.5	34.9	34.4
26	31	40.2	39.8	39.4	39.0	38.6	38.1	37.7	37.2	36.7	36.2	35.7	35.2	34.6	34.1
27	32	39.6	39.3	38.9	38.5	38.1	37.7	37.2	36.8	36.3	35.8	35.3	34.8	34.3	33.7
28	33	39.1	38.7	38.4	38.0	37.6	37.2	36.8	36.3	35.9	35.4	34.9	34.5	33.9	33.4
29	34	38.5	38.2	37.8	37.5	37.1	36.7	36.3	35.9	35.5	35.0	34.6	34.1	33.6	33.1
30	35	37.9	37.6	37.3	36.9	36.6	36.2	35.8	35.4	35.0	34.6	34.1	33.7	33.2	32.7
31	36	37.3	37.0	36.7	36.4	36.0	35.7	35.3	34.9	34.6	34.1	33.7	33.3	32.8	32.3
32	37	36.7	36.4	36.1	35.8	35.5	35.2	34.8	34.5	34.1	33.7	33.3	32.9	32.4	32.0
33	38	36.1	35.8	35.5	35.2	34.9	34.6	34.3	33.9	33.6	33.2	32.8	32.4	32.0	31.6
34	39	35.4	35.2	34.9	34.6	34.4	34.1	33.7	33.4	33.1	32.7	32.3	32.0	31.6	31.1

Ages															
Male	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
Female	40	41	42	43	44	45	46	47	48	49	50	51	52	53	54
6	11	37.0	36.2	35.4	34.6	33.8	33.0	32.2	31.4	30.6	29.8	29.0	28.2	27.5	26.7	25.9
7	12	36.9	36.1	35.3	34.5	33.7	32.9	32.1	31.3	30.5	29.8	29.0	28.2	27.4	26.7	25.9
8	13	36.8	36.0	35.2	34.4	33.7	32.9	32.1	31.3	30.5	29.7	28.9	28.2	27.4	26.6	25.9
9	14	36.7	35.9	35.1	34.4	33.6	32.8	32.0	31.2	30.4	29.7	28.9	28.1	27.3	26.6	25.8
10	15	36.6	35.8	35.1	34.3	33.5	32.7	31.9	31.2	30.4	29.6	28.8	28.1	27.3	26.5	25.8
11	16	36.5	35.7	34.9	34.2	33.4	32.6	31.9	31.1	30.3	29.5	28.8	28.0	27.3	26.5	25.7
12	17	36.4	35.6	34.8	34.1	33.3	32.5	31.8	31.0	30.2	29.5	28.7	28.0	27.2	26.4	25.7
13	18	36.2	35.5	34.7	34.0	33.2	32.4	31.7	30.9	30.2	29.4	28.7	27.9	27.1	26.4	25.7
14	19	36.1	35.3	34.6	33.8	33.1	32.3	31.6	30.8	30.1	29.3	28.6	27.8	27.1	26.3	25.6
15	20	35.9	35.2	34.5	33.7	33.0	32.2	31.5	30.7	30.0	29.3	28.5	27.8	27.0	26.3	25.6
16	21	35.8	35.0	34.3	33.6	32.9	32.1	31.4	30.6	29.9	29.2	28.4	27.7	27.0	26.2	25.5
17	22	35.6	34.9	34.2	33.4	32.7	32.0	31.3	30.5	29.8	29.1	28.3	27.6	26.9	26.2	25.4
18	23	35.4	34.7	34.0	33.3	32.6	31.9	31.2	30.4	29.7	29.0	28.3	27.5	26.8	26.1	25.4
19	24	35.2	34.5	33.8	33.1	32.4	31.7	31.0	30.3	29.6	28.9	28.2	27.4	26.7	26.0	25.3
20	25	35.0	34.3	33.7	33.0	32.3	31.6	30.9	30.2	29.5	28.8	28.1	27.3	26.6	25.9	25.2
21	26	34.8	34.1	33.5	32.8	32.1	31.4	30.7	30.0	29.3	28.6	27.9	27.2	26.5	25.8	25.1
22	27	34.5	33.9	33.3	32.6	31.9	31.3	30.6	29.9	29.2	28.5	27.8	27.1	26.4	25.7	25.1
23	28	34.3	33.7	33.0	32.4	31.7	31.1	30.4	29.7	29.1	28.4	27.7	27.0	26.3	25.6	25.0
24	29	34.0	33.4	32.8	32.2	31.5	30.9	30.2	29.6	28.9	28.2	27.6	26.9	26.2	25.5	24.9
25	30	33.8	33.2	32.6	32.0	31.3	30.7	30.1	29.4	28.8	28.1	27.4	26.8	26.1	25.4	24.8
26	31	33.5	32.9	32.3	31.7	31.1	30.5	29.9	29.2	28.6	27.9	27.3	26.6	26.0	25.3	24.6
27	32	33.2	32.6	32.1	31.5	30.9	30.3	29.6	29.0	28.4	27.3	27.1	26.5	25.8	25.2	24.5
28	33	32.9	32.3	31.8	31.2	30.6	30.0	29.4	28.8	28.2	27.6	27.0	26.3	25.7	25.0	24.4
29	34	32.6	32.0	31.5	30.9	30.4	29.8	29.2	28.6	28.0	27.4	26.8	26.2	25.5	24.9	24.3
30	35	32.2	31.7	31.2	30.6	30.1	29.5	29.0	28.4	27.8	27.2	26.6	26.0	25.4	24.7	24.1
31	36	31.9	31.4	30.9	30.3	29.8	29.3	28.7	28.1	27.6	27.0	26.4	25.8	25.2	24.6	24.0
32	37	31.5	31.0	30.5	30.0	29.5	29.0	28.4	27.9	27.3	26.8	26.2	25.6	25.0	24.4	23.8
33	38	31.1	30.7	30.2	29.7	29.2	28.7	28.2	27.6	27.1	26.5	26.0	25.4	24.8	24.2	23.6
34	39	30.7	30.3	29.8	29.3	28.9	28.4	27.9	27.3	26.8	26.3	25.7	25.2	24.6	24.0	23.5

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages															
Male	50	51	52	53	54	55	56	57	58	59	60	61	62	63
Female	55	56	57	58	59	60	61	62	63	64	65	66	67	68
6	11	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1
7	12	25.1	24.4	23.6	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1
8	13	25.1	24.4	23.6	22.9	22.2	21.4	20.7	20.0	19.4	18.7	18.0	17.4	16.7	16.1
9	14	25.1	24.3	23.6	22.9	22.1	21.4	20.7	20.0	19.3	18.7	18.0	17.3	16.7	16.1
10	15	25.0	24.3	23.6	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1
11	16	25.0	24.3	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1
12	17	25.0	24.2	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.0
13	18	24.9	24.2	23.5	22.7	22.0	21.3	20.6	19.9	19.3	18.6	17.9	17.3	16.7	16.0
14	19	24.9	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.6	17.9	17.3	16.6	16.0
15	20	24.8	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.5	17.9	17.3	16.6	16.0
16	21	24.8	24.0	23.3	22.6	21.9	21.2	20.5	19.9	19.2	18.5	17.9	17.2	16.6	16.0
17	22	24.7	24.0	23.3	22.6	21.9	21.2	20.5	19.8	19.2	18.5	17.8	17.2	16.6	16.0
18	23	24.7	23.9	23.2	22.5	21.8	21.1	20.5	19.8	19.1	18.5	17.8	17.2	16.6	15.9
19	24	24.6	23.9	23.2	22.5	21.8	21.1	20.4	19.8	19.1	18.4	17.8	17.2	16.5	15.9
20	25	24.5	23.8	23.1	22.4	21.7	21.1	20.4	19.7	19.1	18.4	17.8	17.1	16.5	15.9
21	26	24.4	23.7	23.1	22.4	21.7	21.0	20.3	19.7	19.0	18.4	17.7	17.1	16.5	15.9
22	27	24.4	23.7	23.0	22.3	21.6	21.0	20.3	19.6	19.0	18.3	17.7	17.1	16.5	15.9
23	28	24.3	23.6	22.9	22.2	21.6	20.9	20.2	19.6	18.9	18.3	17.7	17.0	16.4	15.8
24	29	24.2	23.5	22.8	22.2	21.5	20.8	20.2	19.5	18.9	18.3	17.6	17.0	16.4	15.8
25	30	24.1	23.4	22.8	22.1	21.4	20.8	20.1	19.5	18.8	18.2	17.6	17.0	16.4	15.8
26	31	24.0	23.3	22.7	22.0	21.4	20.7	20.1	19.4	18.8	18.2	17.5	16.9	16.3	15.7
27	32	23.9	23.2	22.6	21.9	21.3	20.6	20.0	19.4	18.7	18.1	17.5	16.9	16.3	15.7
28	33	23.8	23.1	22.5	21.8	21.2	20.6	19.9	19.3	18.7	18.1	17.4	16.8	16.2	15.6
29	34	23.6	23.0	22.4	21.7	21.1	20.5	19.8	19.2	18.6	18.0	17.4	16.8	16.2	15.6
30	35	23.5	22.9	22.3	21.6	21.0	20.4	19.8	19.1	18.5	17.9	17.3	16.7	16.1	15.6
31	36	23.4	22.7	22.1	21.5	20.9	20.3	19.7	19.1	18.5	17.9	17.3	16.7	16.1	15.5
32	37	23.2	22.6	22.0	21.4	20.8	20.2	19.6	19.0	18.4	17.8	17.2	16.6	16.0	15.5
33	38	23.1	22.5	21.9	21.3	20.7	20.1	19.5	18.9	18.3	17.7	17.1	16.5	16.0	15.4
34	39	22.9	22.3	21.7	21.1	20.5	20.0	19.4	18.8	18.2	17.6	17.0	16.5	15.9	15.3

Ages															
Male	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
Female	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
7	12	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
8	13	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
9	14	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
10	15	15.4	14.8	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
11	16	15.4	14.8	14.2	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
12	17	15.4	14.8	14.2	13.7	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
13	18	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
14	19	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
15	20	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
16	21	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
17	22	15.4	14.8	14.2	13.6	13.0	12.5	12.0	11.5	10.9	10.5	10.0	9.5	9.1	8.6	8.2
18	23	15.3	14.7	14.2	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
19	24	15.3	14.7	14.1	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
20	25	15.3	14.7	14.1	13.6	13.0	12.5	11.9	11.4	10.9	10.4	10.0	9.5	9.0	8.6	8.2
21	26	15.3	14.7	14.1	13.5	13.0	12.5	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
22	27	15.3	14.7	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
23	28	15.2	14.6	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
24	29	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
25	30	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
26	31	15.1	14.6	14.0	13.4	12.9	12.4	11.9	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
27	32	15.1	14.5	14.0	13.4	12.9	12.4	11.8	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
28	33	15.1	14.5	13.9	13.4	12.9	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.6	8.1
29	34	15.0	14.5	13.9	13.4	12.8	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.5	8.1
30	35	15.0	14.4	13.9	13.3	12.8	12.3	11.8	11.3	10.8	10.3	9.8	9.4	9.0	8.5	8.1
31	36	14.9	14.4	13.8	13.3	12.8	12.2	11.7	11.2	10.8	10.3	9.8	9.4	8.9	8.5	8.1
32	37	14.9	14.3	13.8	13.3	12.7	12.2	11.7	11.2	10.7	10.3	9.8	9.4	8.9	8.5	8.1
33	38	14.8	14.3	13.8	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1
34	39	14.8	14.2	13.7	13.2	12.7	12.2	11.	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages																
	Male	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93
Male	Female	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98
6	11	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
7	12	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
8	13	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
9	14	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
10	15	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
11	16	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
12	17	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
13	18	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.1	4.8	4.5	4.2	4.0	3.7	3.5
14	19	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
15	20	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
16	21	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
17	22	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
18	23	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
19	24	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
20	25	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
21	26	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
22	27	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
23	28	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
24	29	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
25	30	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
26	31	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
27	32	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
28	33	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
29	34	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
30	35	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
31	36	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
32	37	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
33	38	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.5	4.2	3.9	3.7	3.5
34	39	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5

Ages																
	Male	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108
Male	Female	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113
6	11	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
7	12	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
8	13	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
9	14	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
10	15	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
11	16	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
12	17	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
13	18	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
14	19	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
15	20	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
16	21	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
17	22	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
18	23	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
19	24	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
20	25	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
21	26	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
22	27	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
23	28	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
24	29	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
25	30	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
26	31	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
27	32	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
28	33	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
29	34	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
30	35	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
31	36	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
32	37	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
33	38	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
34	39	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages																
	Male	35	36	37	38	39	40	41	42	43	44	45	46	47		
Male	Female	40	41	42	43	44	45	46	47	48	49	50	51	52		
35	40	30.3	29.9	29.4	29.0	28.5	28.0	27.5	27.0	26.5	26.0	25.5	24.9	24.4		
36	41	29.9	29.5	29.0	28.6	28.2	27.7	27.2	26.7	26.2	25.7	25.2	24.7	24.2		
37	42	29.4	29.0	28.6	28.2	27.8	27.3	26.9	26.4	25.9	25.5	25.0	24.4	23.9		
38	43	29.0	28.6	28.2	27.8	27.4	27.0	26.5	26.1	25.6	25.2	24.7	24.2	23.7		
39	44	28.5	28.2	27.8	27.4	27.0	26.6	26.2	25.8	25.3	24.8	24.4	23.9	23.4		
40	45	28.0	27.7	27.3	27.0	26.6	26.2	25.8	25.4	25.0	24.5	24.1	23.6	23.1		
41	46	27.5	27.2	26.9	26.5	26.2	25.8	25.4	25.0	24.6	24.2	23.8	23.3	22.9		
42	47	27.0	26.7	26.4	26.1	25.8	25.4	25.0	24.6	24.2	23.8	23.4	23.0	22.6		
43	48	26.5	26.2	25.9	25.6	25.3	25.0	24.6	24.2	23.9	23.5	23.1	22.7	22.2		
44	49	26.0	25.7	25.5	25.2	24.8	24.5	24.2	23.8	23.5	23.1	22.7	22.3	21.9		
45	50	25.5	25.2	25.0,	24.7	24.4	24.1	23.8	23.4	23.1	22.7	22.4	22.0	21.6		
46	51	24.9	24.7	24.4	24.2	23.9	23.6	23.3	23.0	22.7	22.3	22.0	21.6	21.2		
47	52	24.4	24.2	23.9	23.7	23.4	23.1	22.9	22.6	22.2	21.9	21.6	21.2	20.9		

Ages																
	Male	48	49	50	51	52	53	54	55	56	57	58	59	60		
Male	Female	53	54	55	56	57	58	59	60	61	62	63	64	65		
35	40	23.8	23.3	22.7	22.1	21.6	21.0	20.4	19.8	19.3	18.7	18.1	17.5	17.0		
36	41	23.6	23.1	22.5	22.0	21.4	20.8	20.3	19.7	19.1	18.6	18.0	17.4	16.9		
37	42	23.4	22.9	22.3	21.8	21.2	20.7	20.1	19.6	19.0	18.4	17.9	17.3	16.8		
38	43	23.2	22.6	22.1	21.6	21.1	20.5	20.0	19.4	18.9	18.3	17.8	17.2	16.7		
39	44	22.9	22.4	21.9	21.4	20.9	20.3	19.8	19.3	18.7	18.2	17.7	17.1	16.6		
40	45	22.7	22.2	21.7	21.2	20.7	20.1	19.6	19.1	18.6	18.0	17.5	17.0	16.5		
41	46	22.4	21.9	21.4	20.9	20.4	19.9	19.4	18.9	18.4	17.9	17.4	16.9	16.3		
42	47	22.1	21.6	21.2	20.7	20.2	19.7	19.2	18.7	18.2	17.7	17.2	16.7	16.2		
43	48	21.8	21.4	20.9	20.5	20.0	19.5	19.0	18.6	18.1	17.6	17.1	16.6	16.1		
44	49	21.5	21.1	20.6	20.2	19.8	19.3	18.8	18.4	17.9	17.4	16.9	16.4	15.9		
45	50	21.2	20.8	20.4	19.9	19.5	19.1	18.6	18.1	17.7	17.2	16.7	16.3	15.8		
46	51	20.9	20.5	20.1	19.7	19.2	18.8	18.4	17.9	17.5	17.0	16.6	16.1	15.6		
47	52	20.5	20.1	19.8	19.4	19.0	18.5	18.1	17.7	17.3	16.8	16.4	15.9	15.5		
48	53	20.2	19.8	19.4	19.1	18.7	18.3	17.9	17.5	17.0	16.6	16.2	15.7	15.3		
49	54	19.8	19.5	19.1	18.8	18.4	18.0	17.6	17.2	16.8	16.4	16.0	15.5	15.1		
50	55	19.4	19.1	18.8	18.4	18.1	17.7	17.3	16.9	16.6	16.2	15.8	15.3	14.9		
51	56	19.1	18.8	18.4	18.1	17.8	17.4	17.0	16.7	16.3	15.9	15.5	15.1	14.7		
52	57	18.7	18.4	18.1	17.8	17.4	17.1	16.8	16.4	16.0	15.7	15.3	14.9	14.5		
53	58	18.3	18.0	17.7	17.4	17.1	16.8	16.4	16.1	15.8	15.4	15.1	14.7	14.3		
54	59	17.9	17.6	17.3	17.0	16.8	16.4	16.1	15.8	15.5	15.1	14.8	14.4	14.1		
55	60	17.5	17.2	16.9	16.7	16.4	16.1	15.8	15.5	15.2	14.9	14.5	14.2	13.9		
56	61	17.0	16.8	16.6	16.3	16.0	15.8	15.5	15.2	14.9	14.6	14.3	13.9	13.6		
57	62	16.6	16.4	16.2	15.9	15.7	15.4	15.1	14.9	14.6	14.3	14.0	13.7	13.4		
58	63	16.2	16.0	15.8	15.5	15.3	15.1	14.8	14.5	14.3	14.0	13.7	13.4	13.1		
59	64	15.7	15.5	15.3	15.1	14.9	14.7	14.4	14.2	13.9	13.7	13.4	13.1	12.8		
60	65	15.3	15.1	14.9	14.7	14.5	14.3	14.1	13.9	13.6	13.4	13.1	12.8	12.6		

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages														
	Male	61	62	63	64	65	66	67	68	69	70	71	72	73
Male	Female	66	67	68	69	70	71	72	73	74	75	76	77	78
35	40	16.4	15.8	15.3	14.7	14.2	13.7	13.1	12.6	12.1	11.6	11.1	10.7	10.2
36	41	16.3	15.8	15.2	14.7	14.1	13.6	13.1	12.6	12.1	11.6	11.1	10.6	10.2
37	42	16.2	15.7	15.1	14.6	14.1	13.6	13.0	12.5	12.0	11.5	11.1	10.6	10.1
38	43	16.1	15.6	15.1	14.5	14.0	13.5	13.0	12.5	12.0	11.5	11.0	10.6	10.1
39	44	16.0	15.5	15.0	14.5	13.9	13.4	12.9	12.4	11.9	11.5	11.0	10.5	10.1
40	45	15.9	15.4	14.9	14.4	13.9	13.4	12.9	12.4	11.9	11.4	11.0	10.5	10.0
41	46	15.8	15.3	14.8	14.3	13.8	13.3	12.8	12.3	11.8	11.4	10.9	10.5	10.0
42	47	15.7	15.2	14.7	14.2	13.7	13.2	12.7	12.3	11.8	11.3	10.9	10.4	10.0
43	48	15.6	15.1	14.6	14.1	13.6	13.1	12.7	12.2	11.7	11.3	10.8	10.4	9.9
44	49	15.5	15.0	14.5	14.0	13.5	13.1	12.6	12.1	11.7	11.2	10.8	10.3	9.9
45	50	15.3	14.8	14.4	13.9	13.4	13.0	12.5	12.0	11.6	11.1	10.7	10.3	9.8
46	51	15.2	14.7	14.2	13.8	13.3	12.9	12.4	12.0	11.5	11.1	10.6	10.2	9.8
47	52	15.0	14.6	14.1	13.7	13.2	12.8	12.3	11.9	11.4	11.0	10.6	10.1	9.7
48	53	14.9	14.4	14.0	13.5	13.1	12.6	12.2	11.8	11.3	10.9	10.5	10.1	9.7
49	54	14.7	14.3	13.8	13.4	13.0	12.5	12.1	11.7	11.3	10.8	10.4	10.0	9.6
50	55	14.5	14.1	13.7	13.3	12.8	12.4	12.0	11.6	11.2	10.7	10.3	9.9	9.5
51	56	14.3	13.9	13.5	13.1	12.7	12.3	11.9	11.5	11.1	10.7	10.3	9.9	9.5
52	57	14.1	13.7	13.3	12.9	12.5	12.1	11.7	11.3	10.9	10.6	10.2	9.8	9.4
53	58	13.9	13.6	13.2	12.8	12.4	12.0	11.6	11.2	10.8	10.5	10.1	9.7	9.3
54	59	13.7	13.4	13.0	12.6	12.2	11.9	11.5	11.1	10.7	10.3	10.0	9.6	9.2
55	60	13.5	13.2	12.8	12.4	12.1	11.7	11.3	11.0	10.6	10.2	9.9	9.5	9.1
56	61	13.3	12.9	12.6	12.2	11.9	11.5	11.2	10.8	10.5	10.1	9.8	9.4	9.0
57	62	13.0	12.7	12.4	12.1	11.7	11.4	11.0	10.7	10.3	10.0	9.6	9.3	8.9
58	63	12.8	12.5	12.2	11.8	11.5	11.2	10.9	10.5	10.2	9.8	9.5	9.2	8.8
59	64	12.6	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.0	9.7	9.4	9.1	8.7
60	65	12.3	12.0	11.7	11.4	11.1	10.8	10.5	10.2	9.9	9.6	9.3	8.9	8.6
61	66	12.0	11.8	11.5	11.2	10.9	10.6	10.3	10.0	9.7	9.4	9.1	8.8	8.5
62	67	11.8	11.5	11.2	11.0	10.7	10.4	10.1	9.8	9.6	9.3	9.0	8.7	8.4
63	68	11.5	11.2	11.0	10.7	10.5	10.2	9.9	9.7	9.4	9.1	8.8	8.5	8.2
64	69	11.2	11.0	10.7	10.5	10.2	10.0	9.7	9.5	9.2	8.9	8.7	8.4	8.1
65	70	10.9	10.7	10.5	10.2	10.0	9.8	9.5	9.3	9.0	8.8	8.5	8.2	8.0
66	71	10.6	10.4	10.2	10.0	9.8	9.5	9.3	9.1	8.8	8.6	8.3	8.1	7.8
67	72	10.3	10.1	9.9	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.1	7.9	7.7
68	73	10.0	9.8	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.2	8.0	7.7	7.5
69	74	9.7	9.6	9.4	9.2	9.0	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.3
70	75	9.4	9.3	9.1	8.9	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.4	7.2
71	76	9.1	9.0	8.8	8.7	8.5	8.3	8.1	8.0	7.8	7.6	7.4	7.2	7.0
72	77	8.8	8.7	8.5	8.4	8.2	8.1	7.9	7.7	7.6	7.4	7.2	7.0	6.8
73	78	8.5	8.4	8.2	8.1	8.0	7.8	7.7	7.5	7.3	7.2	7.0	6.8	6.7

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages														
	Male	74	75	76	77	78	79	80	81	82	83	84	85	86
Male	Female	79	80	81	82	83	84	85	86	87	88	89	90	91
35	40	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
36	41	9.7	9.3	8.9	8.4	8.0	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
37	42	9.7	9.3	8.8	8.4	8.0	7.6	7.3	6.9	6.5	6.2	5.9	5.6	5.3
38	43	9.7	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
39	44	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
40	45	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.5	5.2
41	46	9.6	9.2	8.7	8.3	7.9	7.6	7.2	6.8	6.5	6.2	5.8	5.5	5.2
42	47	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.2	5.8	5.5	5.2
43	48	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.1	5.8	5.5	5.2
44	49	9.5	9.0	8.6	8.2	7.9	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
45	50	9.4	9.0	8.6	8.2	7.8	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
46	51	9.4	9.0	8.6	8.2	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
47	52	9.3	8.9	8.5	8.1	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
48	53	9.3	8.9	8.5	8.1	7.7	7.4	7.0	6.7	6.4	6.0	5.7	5.4	5.1
49	54	9.2	8.8	8.4	8.1	7.7	7.3	7.0	6.7	6.3	6.0	5.7	5.4	5.1
50	55	9.1	8.8	8.4	8.0	7.7	7.3	7.0	6.6	6.3	6.0	5.7	5.4	5.1
51	56	9.1	8.7	8.3	8.0	7.6	7.3	6.9	6.6	6.3	6.0	5.7	5.4	5.1
52	57	9.0	8.6	8.3	7.9	7.6	7.2	6.9	6.6	6.2	5.9	5.6	5.4	5.1
53	58	8.9	8.6	8.2	7.9	7.5	7.2	6.9	6.5	6.2	5.9	5.6	5.3	5.1
54	59	8.9	8.5	8.2	7.8	7.5	7.1	6.8	6.5	6.2	5.9	5.6	5.3	5.0
55	60	8.8	8.4	8.1	7.7	7.4	7.1	6.8	6.4	6.1	5.8	5.6	5.3	5.0
56	61	8.7	8.4	8.0	7.7	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.3	5.0
57	62	8.6	8.3	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.2	5.0
58	63	8.5	8.2	7.9	7.5	7.2	6.9	6.6	6.3	6.0	5.7	5.5	5.2	4.9
59	64	8.4	8.1	7.8	7.5	7.1	6.8	6.5	6.3	6.0	5.7	5.4	5.2	4.9
60	65	8.3	8.0	7.7	7.4	7.1	6.8	6.5	6.2	5.9	5.6	5.4	5.1	4.9
61	66	8.2	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.9	5.6	5.3	5.1	4.8
62	67	8.1	7.8	7.5	7.2	6.9	6.6	6.4	6.1	5.8	5.5	5.3	5.0	4.8
63	68	8.0	7.7	7.4	7.1	6.8	6.6	6.3	6.0	5.7	5.5	5.2	5.0	4.7
64	69	7.8	7.6	7.3	7.0	6.7	6.5	6.2	5.9	5.7	5.4	5.2	4.9	4.7
65	70	7.7	7.4	7.2	6.9	6.6	6.4	6.1	5.9	5.6	5.4	5.1	4.9	4.7
66	71	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5	5.3	5.1	4.8	4.6
67	72	7.4	7.2	6.9	6.7	6.4	6.2	6.0	5.7	5.5	5.2	5.0	4.8	4.6
68	73	7.3	7.0	6.8	6.6	6.3	6.1	5.9	5.6	5.4	5.2	4.9	4.7	4.5
69	74	7.1	6.9	6.7	6.4	6.2	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5
70	75	7.0	6.8	6.5	6.3	6.1	5.9	5.7	5.4	5.2	5.0	4.8	4.6	4.4
71	76	6.8	6.6	6.4	6.2	6.0	5.8	5.6	5.3	5.1	4.9	4.7	4.5	4.3
72	77	6.6	6.4	6.3	6.1	5.9	5.7	5.5	5.3	5.0	4.9	4.7	4.5	4.3
73	78	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.1	5.0	4.8	4.6	4.4	4.2
74	79	6.3	6.1	6.0	5.8	5.6	5.4	5.2	5.0	4.9	4.7	4.5	4.3	4.1
75	80	6.1	6.0	5.8	5.6	5.5	5.3	5.1	4.9	4.8	4.6	4.4	4.2	4.1
76	81	6.0	5.8	5.6	5.5	5.3	5.2	5.0	4.8	4.7	4.5	4.3	4.1	4.0
77	82	5.8	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.5	4.4	4.2	4.1	3.9
78	83	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.6	4.4	4.3	4.1	4.0	3.8
79	84	5.4	5.3	5.2	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.0	3.9	3.7
80	85	5.2	5.1	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.6
81	86	5.0	4.9	4.8	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.7	3.6
82	87	4.9	4.8	4.7	4.5	4.4	4.3	4.2	4.1	4.0	3.8	3.7	3.6	3.5
83	88	4.7	4.6	4.5	4.4	4.3	4.2	4.1	3.9	3.8	3.7	3.6	3.5	3.4
84	89	4.5	4.4	4.3	4.2	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3
85	90	4.3	4.2	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3	3.2
86	91	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.6	3.5	3.4	3.3	3.2	3.1

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages												
Male	Male	87	88	89	90	91	92	93	94	95	96	97
	Female	92	93	94	95	96	97	98	99	100	101	102
35	40	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
36	41	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
37	42	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
38	43	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.8	2.6
39	44	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
40	45	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
41	46	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
42	47	4.9	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
43	48	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2	3.0	2.8	2.6
44	49	4.9	4.7	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
45	50	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
46	51	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
47	52	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
48	53	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
49	54	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
50	55	4.8	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
51	56	4.8	4.6	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
52	57	4.8	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
53	58	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
54	59	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
55	60	4.7	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
56	61	4.7	4.5	4.2	4.0	3.8	3.6	3.3	3.1	2.9	2.8	2.6
57	62	4.7	4.5	4.2	4.0	3.8	3.5	3.3	3.1	2.9	2.7	2.6
58	63	4.7	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.7	2.5
59	64	4.6	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5

Ages												
	Male	98	99	100	101	102	103	104	105	106	107	108
Male	Female	103	104	105	106	107	108	109	110	111	112	113
35	40	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
36	41	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
37	42	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
38	43	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
39	44	2.4	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
40	45	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
41	46	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
42	47	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
43	48	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
44	49	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	0.8	0.7
45	50	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
46	51	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
47	52	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
48	53	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
49	54	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	0.8	0.7
50	55	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
51	56	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
52	57	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
53	58	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
54	59	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7
55	60	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7
56	61	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7
57	62	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
58	63	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
59	64	2.3	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages												
	Male	87	88	89	90	91	92	93	94	95	96	97
Male	Female	92	93	94	95	96	97	98	99	100	101	102
60	65	4.6	4.4	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
61	66	4.6	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
62	67	4.5	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
63	68	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5
64	69	4.5	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.7	2.5
65	70	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.5
66	71	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4
67	72	4.3	4.1	3.9	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.4
68	73	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.8	2.6	2.4
69	74	4.2	4.0	3.8	3.6	3.5	3.3	3.1	2.9	2.7	2.6	2.4
70	75	4.2	4.0	3.8	3.6	3.4	3.2	3.1	2.9	2.7	2.5	2.4
71	76	4.1	3.9	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5	2.3
72	77	4.1	3.9	3.7	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.3
73	78	4.0	3.8	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.5	2.3
74	79	3.9	3.8	3.6	3.4	3.3	3.1	2.9	2.8	2.6	2.4	2.3
75	80	3.9	3.7	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.4	2.2
76	81	3.8	3.6	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.4	2.2
77	82	3.7	3.6	3.4	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2
78	83	3.7	3.5	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.1
79	84	3.6	3.4	3.3	3.1	3.0	2.8	2.7	2.5	2.4	2.2	2.1
80	85	3.5	3.4	3.2	3.1	2.9	2.8	2.6	2.5	2.3	2.2	2.0
81	86	3.4	3.3	3.1	3.0	2.9	2.7	2.6	2.4	2.3	2.1	2.0
82	87	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.2	2.1	2.0
83	88	3.2	3.1	3.0	2.9	2.7	2.6	2.5	2.3	2.2	2.0	1.9
84	89	3.1	3.0	2.9	2.8	2.7	2.5	2.4	2.3	2.1	2.0	1.9

Ages												
	Male	98	99	100	101	102	103	104	105	106	107	108
Male	Female	103	104	105	106	107	108	109	110	111	112	113
60	65	2.3	2.1	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
61	66	2.3	2.1	2.0	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
62	67	2.3	2.1	1.9	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7
63	68	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
64	69	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
65	70	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	0.9	0.8	0.7
66	71	2.3	2.1	1.9	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7
67	72	2.2	2.1	1.9	1.7	1.5	1.4	1.2	1.0	0.9	0.7	0.7
68	73	2.2	2.0	1.9	1.7	1.5	1.4	1.2	1.0	0.9	0.7	0.7
69	74	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.6
70	75	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	0.9	0.7	0.6
71	76	2.2	2.0	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.7	0.6
72	77	2.1	2.0	1.8	1.6	1.5	1.3	1.1	1.0	0.8	0.7	0.6
73	78	2.1	1.9	1.8	1.6	1.4	1.3	1.1	1.0	0.8	0.7	0.6
74	79	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.8	0.7	0.6
75	80	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.8	0.7	----
76	81	2.0	1.9	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7	----
77	82	2.0	1.8	1.7	1.5	1.4	1.2	1.1	0.9	0.8	0.7	----
78	83	2.0	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	----
79	84	1.9	1.8	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.7	----
80	85	1.9	1.7	1.6	1.4	1.3	1.1	1.0	0.9	0.7	0.7	----
81	86	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.8	0.7	0.6	----
82	87	1.8	1.7	1.5	1.4	1.2	1.1	1.0	0.8	0.7	0.6	----
83	88	1.8	1.6	1.5	1.3	1.2	1.1	0.9	0.8	0.7	0.6	----
84	89	1.7	1.6	1.4	1.3	1.2	1.0	0.9	0.8	0.7	----	----

TABLE IIA—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages											
	Male	87	88	89	90	91	92	93	94	95	96
Male	Female	92	93	94	95	96	97	98	99	100	101
85	90	3.1	2.9	2.8	2.7	2.6	2.5	2.3	2.2	2.1	1.9
86	91	3.0	2.8	2.7	2.6	2.5	2.4	2.3	2.1	2.0	1.9
87	92	2.9	2.8	2.6	2.5	2.4	2.3	2.2	2.1	1.9	1.8
88	93	2.8	2.7	2.6	2.4	2.3	2.2	2.1	2.0	1.9	1.7
89	94	2.6	2.6	2.5	2.4	2.2	2.1	2.0	1.9	1.8	1.7
90	95	2.5	2.4	2.4	2.3	2.2	2.0	1.9	1.8	1.7	1.6
91	96	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.7	1.6	1.5
92	97	2.3	2.2	2.1	2.0	2.0	1.9	1.8	1.7	1.6	1.5
93	98	2.2	2.1	2.0	1.9	1.9	1.8	1.7	1.6	1.5	1.4
94	99	2.1	2.0	1.9	1.8	1.7	1.7	1.6	1.5	1.4	1.3
95	100	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4	1.3	1.2
96	101	1.8	1.7	1.7	1.6	1.5	1.5	1.4	1.3	1.2	1.1
97	102	1.7	1.6	1.6	1.5	1.4	1.4	1.3	1.2	1.1	1.1
98	103	1.6	1.5	1.4	1.4	1.3	1.3	1.2	1.1	1.0	1.0
99	104	1.4	1.4	1.3	1.3	1.2	1.1	1.1	1.0	1.0	0.9

Ages											
	Male	97	98	99	100	101	102	103	104	105	106
Male	Female	102	103	104	105	106	107	108	109	110	111
85	90	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7
86	91	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.7
87	92	1.7	1.6	1.4	1.3	1.2	1.1	0.9	0.8	0.7	0.6
88	93	1.6	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7	0.6
89	94	1.6	1.4	1.3	1.2	1.1	1.0	0.9	0.7	0.7	----
90	95	1.5	1.4	1.3	1.2	1.0	0.9	0.8	0.7	0.6	----
91	96	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	----
92	97	1.4	1.3	1.1	1.0	0.9	0.8	0.7	0.7	----	----
93	98	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	----	----
94	99	1.2	1.1	1.0	0.9	0.8	0.7	0.7	----	----	----
95	100	1.1	1.0	1.0	0.9	0.8	0.7	0.6	----	----	----
96	101	1.1	1.0	0.9	0.8	0.7	0.7	----	----	----	----
97	102	1.0	0.9	0.8	0.7	0.7	0.6	----	----	----	----
98	103	0.9	0.8	0.7	0.7	0.6	----	----	----	----	----
99	104	0.8	0.7	0.7	0.6	----	----	----	----	----	----

TABLE III—PERCENT VALUE OF REFUND FEATURE

Ages		Duration of guaranteed amount												
Male	Female	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years	9 years	10 years	11 years	12 years	13 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
6	11	----	----	----	----	----	----	----	----	1	1	1	1	1
7	12	----	----	----	----	----	----	----	----	1	1	1	1	1
8	13	----	----	----	----	----	----	----	1	1	1	1	1	1
9	14	----	----	----	----	----	----	----	1	1	1	1	1	1
10	15	----	----	----	----	----	----	----	1	1	1	1	1	1
11	16	----	----	----	----	----	----	----	1	1	1	1	1	1
12	17	----	----	----	----	----	----	----	1	1	1	1	1	1
13	18	----	----	----	----	----	----	----	1	1	1	1	1	1
14	19	----	----	----	----	----	----	----	1	1	1	1	1	1
15	20	----	----	----	----	----	----	----	1	1	1	1	1	1
16	21	----	----	----	----	----	----	----	1	1	1	1	1	1
17	22	----	----	----	----	----	----	----	1	1	1	1	1	1
18	23	----	----	----	----	----	----	----	1	1	1	1	1	1
19	24	----	----	----	----	----	----	----	1	1	1	1	1	1
20	25	----	----	----	----	----	----	----	1	1	1	1	1	1
21	26	----	----	----	----	----	----	----	1	1	1	1	1	1
22	27	----	----	----	----	----	----	1	1	1	1	1	1	1
23	28	----	----	----	----	----	----	1	1	1	1	1	1	1
24	29	----	----	----	----	----	----	1	1	1	1	1	1	1
25	30	----	----	----	----	----	----	1	1	1	1	1	1	1
26	31	----	----	----	----	----	1	1	1	1	1	1	1	1
27	32	----	----	----	----	----	1	1	1	1	1	1	1	1
28	33	----	----	----	----	----	1	1	1	1	1	1	1	1
29	34	----	----	----	----	----	1	1	1	1	1	1	1	2
30	35	----	----	----	----	1	1	1	1	1	1	1	2	2
31	36	----	----	----	----	1	1	1	1	1	1	1	2	2
32	37	----	----	----	----	1	1	1	1	1	1	2	2	2
33	38	----	----	----	1	1	1	1	1	1	1	2	2	2
34	39	----	----	----	1	1	1	1	1	1	2	2	2	2
35	40	----	----	----	1	1	1	1	1	2	2	2	2	2
36	41	----	----	----	1	1	1	1	1	2	2	2	2	3
37	42	----	----	1	1	1	1	1	2	2	2	2	3	3
38	43	----	----	1	1	1	1	1	2	2	2	2	3	3
39	44	----	----	1	1	1	1	2	2	2	2	3	3	3
40	45	----	----	1	1	1	1	2	2	2	3	3	3	4
41	46	----	----	1	1	1	1	2	2	2	3	3	3	4
42	47	----	----	1	1	1	2	2	2	3	3	3	4	4
43	48	----	1	1	1	1	2	2	2	3	3	4	4	4
44	49	----	1	1	1	1	2	2	3	3	3	4	4	5
45	50	----	1	1	1	2	2	2	3	3	4	4	5	5
46	51	----	1	1	1	2	2	3	3	3	4	4	5	5
47	52	----	1	1	1	2	2	3	3	4	4	5	5	6
48	53	----	1	1	2	2	2	3	3	4	5	5	6	6
49	54	----	1	1	2	2	3	3	4	4	5	5	6	7
50	55	----	1	1	2	2	3	3	4	5	5	6	7	7
51	56	----	1	1	2	3	3	4	4	5	6	6	7	8
52	57	1	1	2	2	3	3	4	5	5	6	7	8	8
53	58	1	1	2	2	3	4	4	5	6	7	7	8	9
54	59	1	1	2	2	3	4	5	5	6	7	8	9	10
55	60	1	1	2	3	3	4	5	6	7	8	8	9	10
56	61	1	1	2	3	4	4	5	6	7	8	9	10	11
57	62	1	1	2	3	4	5	6	7	8	9	10	11	12
58	63	1	2	2	3	4	5	6	7	8	9	10	12	13
59	64	1	2	3	4	5	6	7	8	9	10	11	12	14
60	65	1	2	3	4	5	6	7	8	10	11	12	13	15
61	66	1	2	3	4	5	6	8	9	10	12	13	14	16
62	67	1	2	3	4	6	7	8	10	11	12	14	15	17
63	68	1	2	4	5	6	7	9	10	12	13	15	16	18
64	69	1	3	4	5	7	8	9	11	13	14	16	17	19
65	70	1	3	4	6	7	9	10	12	13	15	17	19	20
66	71	1	3	4	6	8	9	11	13	14	16	18	20	22
67	72	2	3	5	6	8	10	12	14	15	17	19	21	23
68	73	2	3	5	7	9	11	13	14	16	18	21	23	25
69	74	2	4	6	7	9	11	13	16	18	20	22	24	26
70	75	2	4	6	8	10	12	14	17	19	21	23	26	28

TABLE III—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount												
Male	Female	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years	9 years	10 years	11 years	12 years	13 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
71	76	2	4	6	9	11	13	15	18	20	22	25	27	29
72	77	2	5	7	9	12	14	16	19	21	24	26	29	31
73	78	2	5	7	10	12	15	18	20	23	25	28	30	33
74	79	3	5	8	11	13	16	19	22	24	27	30	32	35
75	80	3	6	8	11	14	17	20	23	26	29	31	34	37
76	81	3	6	9	12	15	18	21	24	27	30	33	36	39
77	82	3	7	10	13	16	20	23	26	29	32	35	38	41
78	83	4	7	11	14	17	21	24	28	31	34	37	40	43
79	84	4	8	11	15	19	22	26	29	33	36	39	42	45
80	85	4	8	12	16	20	24	27	31	34	38	41	44	47
81	86	4	9	13	17	21	25	29	33	36	40	43	46	49
82	87	5	9	14	18	23	27	31	35	38	42	45	48	51
83	88	5	10	15	19	24	28	33	37	40	44	47	50	53
84	89	5	11	16	21	26	30	34	38	42	46	49	52	55
85	90	6	11	17	22	27	32	36	41	44	48	51	55	57

Ages		Duration of guaranteed amount												
Male	Female	14 years	15 years	16 years	17 years	18 years	19 years	20 years	21 years	22 years	23 years	24 years	25 years	26 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
6	11	1	1	1	1	1	1	1	1	1	1	2	2	2
7	12	1	1	1	1	1	1	1	1	1	1	2	2	2
8	13	1	1	1	1	1	1	1	1	1	1	2	2	2
9	14	1	1	1	1	1	1	1	1	1	1	2	2	2
10	15	1	1	1	1	1	1	1	1	1	2	2	2	2
11	16	1	1	1	1	1	1	1	1	1	2	2	2	2
12	17	1	1	1	1	1	1	1	1	1	2	2	2	2
13	18	1	1	1	1	1	1	1	1	2	2	2	2	2
14	19	1	1	1	1	1	1	1	1	2	2	2	2	2
15	20	1	1	1	1	1	1	1	1	2	2	2	2	2
16	21	1	1	1	1	1	1	1	2	2	2	2	2	2
17	22	1	1	1	1	1	1	1	2	2	2	2	2	2
18	23	1	1	1	1	1	1	2	2	2	2	2	2	2
19	24	1	1	1	1	1	2	2	2	2	2	2	2	2
20	25	1	1	1	1	1	2	2	2	2	2	2	2	3
21	26	1	1	1	1	2	2	2	2	2	2	2	3	3
22	27	1	1	1	1	2	2	2	2	2	2	3	3	3
23	28	1	1	1	2	2	2	2	2	2	2	3	3	3
24	29	1	1	2	2	2	2	2	2	2	3	3	3	3
25	30	1	1	2	2	2	2	2	2	3	3	3	3	3
26	31	1	2	2	2	2	2	2	3	3	3	3	3	4
27	32	2	2	2	2	2	2	3	3	3	3	3	4	4
28	33	2	2	2	2	2	3	3	3	3	3	4	4	4
29	34	2	2	2	2	2	3	3	3	3	4	4	4	5
30	35	2	2	2	2	3	3	3	3	4	4	4	5	5
31	36	2	2	2	3	3	3	3	4	4	4	5	5	5
32	37	2	2	3	3	3	3	4	4	4	5	5	5	6
33	38	2	3	3	3	3	4	4	4	5	5	5	6	6
34	39	3	3	3	3	4	4	4	5	5	5	6	6	7
35	40	3	3	3	4	4	4	5	5	5	6	6	7	7
36	41	3	3	4	4	4	5	5	5	6	6	7	7	8
37	42	3	3	4	4	4	5	5	6	6	7	7	8	8
38	43	3	4	4	4	5	5	6	6	7	7	8	8	9
39	44	4	4	4	5	5	6	6	7	7	8	8	9	9
40	45	4	4	5	5	6	6	7	7	8	8	9	9	10
41	46	4	5	5	6	6	7	7	8	8	9	9	10	11
42	47	5	5	5	6	6	7	8	8	9	9	10	11	12
43	48	5	5	6	6	7	8	8	9	9	10	11	12	12
44	49	5	6	6	7	7	8	9	9	10	11	12	12	13
45	50	6	6	7	7	8	9	9	10	11	12	12	13	14

TABLE III—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount												
Male	Female	14 years	15 years	16 years	17 years	18 years	19 years	20 years	21 years	22 years	23 years	24 years	25 years	26 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
46	51	6	7	7	8	9	9	10	11	12	12	13	14	15
47	52	7	7	8	9	9	10	11	12	12	13	14	15	16
48	53	7	8	8	9	10	11	12	12	13	14	15	16	17
49	54	8	8	9	10	11	11	12	13	14	15	16	17	18
50	55	8	9	10	11	11	12	13	14	15	16	17	18	20
51	56	9	10	10	11	12	13	14	15	16	17	18	20	21
52	57	9	10	11	12	13	14	15	16	17	18	20	21	22
53	58	10	11	12	13	14	15	16	17	19	20	21	22	24
54	59	11	12	13	14	15	16	17	18	20	21	22	24	25
55	60	11	13	14	15	16	17	18	20	21	22	24	25	26
56	61	12	13	15	16	17	18	20	21	22	24	25	27	28
57	62	13	14	16	17	18	20	21	22	24	25	27	28	30
58	63	14	15	17	18	19	21	22	24	25	27	28	30	31
59	64	15	16	18	19	21	22	24	25	27	28	30	31	33
60	65	16	18	19	20	22	24	25	27	28	30	32	33	35
61	66	17	19	20	22	23	25	27	28	30	32	33	35	37
62	67	18	20	22	23	25	27	28	30	32	33	35	37	38
63	68	20	21	23	25	26	28	30	32	33	35	37	39	40
64	69	21	23	24	26	28	30	32	33	35	37	39	41	42
65	70	22	24	26	28	30	32	33	35	37	39	41	42	44
66	71	24	26	28	29	31	33	35	37	39	41	43	44	46
67	72	25	27	29	31	33	35	37	39	41	43	45	46	48
68	73	27	29	31	33	35	37	39	41	43	45	47	48	50
69	74	28	30	33	35	37	39	41	43	45	47	48	50	52
70	75	30	32	34	37	39	41	43	45	47	49	50	52	54
71	76	32	34	36	39	41	43	45	47	49	51	52	54	56
72	77	34	36	38	41	43	45	47	49	51	53	54	56	58
73	78	35	38	40	43	45	47	49	51	53	55	56	58	59
74	79	37	40	42	45	47	49	51	53	55	57	58	60	61
75	80	39	42	44	47	49	51	53	55	57	58	60	62	63
76	81	41	44	46	49	51	53	55	57	59	60	62	63	65
77	82	43	46	48	51	53	55	57	59	61	62	64	65	66
78	83	45	48	50	53	55	57	59	61	62	64	65	67	68
79	84	48	50	53	55	57	59	61	63	64	66	67	68	70
80	85	50	52	55	57	59	61	63	64	66	67	69	70	71
81	86	52	54	57	59	61	63	65	66	68	69	70	72	73
82	87	54	56	59	61	63	65	66	68	69	71	72	73	74
83	88	56	58	61	63	65	66	68	70	71	72	73	74	75
84	89	58	60	63	65	67	68	70	71	73	74	75	76	77
85	90	60	62	65	67	68	70	71	73	74	75	76	77	-------

Ages		Duration of guaranteed amount								
Male	Female	27 years	28 years	29 years	30 years	31 years	32 years	33 years	34 years	35 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
6	11	2	2	2	2	2	2	2	2	2
7	12	2	2	2	2	2	2	2	2	3
8	13	2	2	2	2	2	2	2	2	3
9	14	2	2	2	2	2	2	2	3	3
10	15	2	2	2	2	2	2	3	3	3
11	16	2	2	2	2	2	2	3	3	3
12	17	2	2	2	2	2	3	3	3	3
13	18	2	2	2	2	2	3	3	3	3
14	19	2	2	2	2	3	3	3	3	3
15	20	2	2	2	3	3	3	3	3	3
16	21	2	2	3	3	3	3	3	3	4
17	22	2	2	3	3	3	3	3	4	4
18	23	2	3	3	3	3	3	4	4	4
19	24	3	3	3	3	3	4	4	4	4
20	25	3	3	3	3	4	4	4	4	5

TABLE III—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount								
Male	Female	27 years	28 years	29 years	30 years	31 years	32 years	33 years	34 years	35 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
21	26	3	3	3	4	4	4	4	5	5
22	27	3	3	4	4	4	4	5	5	5
23	28	3	3	4	4	4	5	5	5	5
24	29	3	4	4	4	5	5	5	5	6
25	30	4	4	4	5	5	5	6	6	6
26	31	4	4	5	5	5	6	6	6	7
27	32	4	5	5	5	6	6	6	7	7
28	33	5	5	5	6	6	6	7	7	8
29	34	5	5	6	6	6	7	7	8	8
30	35	5	6	6	6	7	7	8	8	9
31	36	6	6	6	7	7	8	8	9	9
32	37	6	7	7	7	8	8	9	10	10
33	38	7	7	7	8	8	9	10	10	11
34	39	7	8	8	9	9	10	10	11	12
35	40	8	8	9	9	10	10	11	12	12
36	41	8	9	9	10	10	11	12	13	13
37	42	9	9	10	11	11	12	13	13	14
38	43	9	10	11	11	12	13	13	14	15
39	44	10	11	11	12	13	14	14	15	16
40	45	11	11	12	13	14	15	15	16	17
41	46	11	12	13	14	15	16	16	17	18
42	47	12	13	14	15	16	17	18	18	19
43	48	13	14	15	16	17	18	19	20	21
44	49	14	15	16	17	18	19	20	21	22
45	50	15	16	17	18	19	20	21	22	23
46	51	16	17	18	19	20	21	22	24	25
47	52	17	18	19	20	21	23	24	25	26
48	53	18	19	20	22	23	24	25	26	28
49	54	19	21	22	23	24	25	27	28	29
50	55	21	22	23	24	26	27	28	29	31
51	56	22	23	25	26	27	28	30	31	32
52	57	23	25	26	27	29	30	31	33	34
53	58	25	26	28	29	30	32	33	34	36
54	59	26	28	29	31	32	33	35	36	38
55	60	28	29	31	32	34	35	36	38	39
56	61	29	31	32	34	35	37	38	40	41
57	62	31	33	34	36	37	39	40	41	43
58	63	33	34	36	37	39	40	42	43	45
59	64	35	36	38	39	41	42	44	45	47
60	65	36	38	40	41	43	44	46	47	48
61	66	38	40	41	43	44	46	47	49	50
62	67	40	42	43	45	46	48	49	51	52
63	68	42	44	45	47	48	50	51	52	54
64	69	44	46	47	49	50	52	53	54	55
65	70	46	47	49	50	52	53	55	56	57
66	71	48	49	51	52	54	55	56	58	59
67	72	50	51	53	54	56	57	58	59	61
68	73	52	53	55	56	57	59	60	61	62
69	74	53	55	56	58	59	60	62	63	64
70	75	55	57	58	60	61	62	63	64	65
71	76	57	59	60	61	63	64	65	66	67
72	77	59	60	62	63	64	65	66	67	68
73	78	61	62	64	65	66	67	68	69	70
74	79	63	64	65	66	67	68	69	70	71
75	80	64	66	67	68	69	70	71	72	72
76	81	66	67	68	69	70	71	72	73	----------
77	82	68	69	70	71	72	73	74	----------	----------
78	83	69	70	71	72	73	74	----------	----------	----------
79	84	71	72	73	74	75	----------	----------	----------	----------
80	85	72	73	74	75	----------	----------	----------	----------	----------
81	86	74	75	75	----------	----------	----------	----------	----------	----------
82	87	75	76	----------	----------	----------	----------	----------	----------	----------
83	88	76	----------	----------	----------	----------	----------	----------	----------	----------
84	89	----------	----------	----------	----------	----------	----------	----------	----------	----------
85	90	----------	----------	----------	----------	----------	----------	----------	----------	----------

TABLE III—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount													
Male	Female	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years	9 years	10 years	11 years	12 years	13 years	14 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
86	91	6	12	18	24	29	34	38	43	47	50	54	57	59	62
87	92	7	13	19	25	31	36	40	45	49	52	56	59	61	64
88	93	7	14	21	27	32	38	42	47	51	55	58	61	63	66
89	94	8	15	22	28	34	40	45	49	53	57	60	63	65	68
90	95	8	16	23	30	36	42	47	51	55	59	62	65	67	70
91	96	9	17	25	32	38	44	49	53	57	61	64	67	69	71
92	97	9	18	26	34	40	46	51	55	59	63	66	69	71	73
93	98	10	20	28	36	42	48	53	58	62	65	68	70	73	75
94	99	11	21	30	37	44	50	55	60	64	67	70	72	74	76
95	100	12	22	31	39	46	52	58	62	66	69	72	74	76	78
96	101	12	24	33	42	49	55	60	64	68	71	73	76	78	79
97	102	13	25	35	44	51	57	62	66	70	73	75	77	79	----------
98	103	14	27	37	46	54	60	65	69	72	75	77	79	----------	----------
99	104	15	29	40	49	56	62	67	71	74	77	79	----------	----------	----------
100	105	17	31	43	52	59	65	70	74	76	79	----------	----------	----------	----------
101	106	18	33	46	55	63	68	73	76	79	----------	----------	----------	----------	----------
102	107	20	36	49	59	66	71	75	78	----------	----------	----------	----------	----------	----------
103	108	22	40	53	62	69	74	78	----------	----------	----------	----------	----------	----------	----------
104	109	24	43	57	66	73	77	----------	----------	----------	----------	----------	----------	----------	----------
105	110	27	48	61	70	76	----------	----------	----------	----------	----------	----------	----------	----------	----------
106	111	31	53	66	74	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------
107	112	35	58	71	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------
108	113	40	64	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------

Ages		Duration of guaranteed amount										
Male	Female	15 years	16 years	17 years	18 years	19 years	20 years	21 years	22 years	23 years	24 years	25 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
86	91	64	66	68	70	72	73	74	75	76	77	----------
87	92	66	68	70	72	73	74	76	77	78	----------	----------
88	93	68	70	72	73	75	76	77	78	----------	----------	----------
89	94	70	72	73	75	76	77	78	----------	----------	----------	----------
90	95	72	73	75	76	77	79	----------	----------	----------	----------	----------
91	96	73	75	76	78	79	----------	----------	----------	----------	----------	----------
92	97	75	76	78	79	----------	----------	----------	----------	----------	----------	----------
93	98	76	78	79	----------	----------	----------	----------	----------	----------	----------	----------
94	99	78	79	----------	----------	----------	----------	----------	----------	----------	----------	----------
95	100	79	----------	----------	----------	----------	----------	----------	----------	----------	----------	----------

TABLE IV—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	1	2	3	4	5	6	7	8	9	10
0 to 8	0 to 13	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
9	14	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
10	15	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
11	16	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
12	17	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
13	18	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
14	19	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
15	20	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
16	21	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
17	22	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
18	23	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
19	24	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
20	25	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
21	26	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
22	27	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
23	28	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
24	29	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
25	30	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
26	31	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
27	32	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
28	33	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
29	34	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
30	35	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
31	36	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
32	37	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
33	38	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
34	39	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
35	40	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
36	41	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
37	42	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
38	43	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
39	44	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.9	8.8	9.8
40	45	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
41	46	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
42	47	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
43	48	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
44	49	1.0	2.0	3.0	4.0	4.9	5.9	6.8	7.8	8.7	9.7
45	50	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
46	51	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
47	52	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.7	9.6
48	53	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.6	9.5
49	54	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
50	55	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
51	56	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.7	8.6	9.4
52	57	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.6	8.5	9.4
53	58	1.0	2.0	2.9	3.9	4.9	5.8	6.7	7.6	8.5	9.3
54	59	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.6	8.4	9.3
55	60	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.5	8.4	9.2
56	61	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.4	9.2
57	62	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.3	9.1
58	63	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.4	8.3	9.1
59	64	1.0	2.0	2.9	3.9	4.8	5.7	6.5	7.4	8.2	9.0
60	65	1.0	2.0	2.9	3.8	4.8	5.6	6.5	7.3	8.1	8.9
61	66	1.0	2.0	2.9	3.8	4.7	5.6	6.5	7.3	8.1	8.8
62	67	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	8.0	8.8
63	68	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	7.9	8.7
64	69	1.0	1.9	2.9	3.8	4.7	5.5	6.3	7.1	7.9	8.6
65	70	1.0	1.9	2.9	3.8	4.6	5.5	6.3	7.1	7.8	8.5
66	71	1.0	1.9	2.9	3.8	4.6	5.4	6.2	7.0	7.7	8.4
67	72	1.0	1.9	2.9	3.7	4.6	5.4	6.2	6.9	7.6	8.3
68	73	1.0	1.9	2.8	3.7	4.6	5.4	6.1	6.8	7.5	8.2
69	74	1.0	1.9	2.8	3.7	4.5	5.3	6.1	6.8	7.4	8.0
70	75	1.0	1.9	2.8	3.7	4.5	5.3	6.0	6.7	7.3	7.9

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of § 1.72–5.

TABLE IV—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	1	2	3	4	5	6	7	8	9	10
71	76	1.0	1.9	2.8	3.7	4.5	5.2	5.9	6.6	7.2	7.8
72	77	1.0	1.9	2.8	3.6	4.4	5.2	5.8	6.5	7.1	7.6
73	78	1.0	1.9	2.8	3.6	4.4	5.1	5.8	6.4	7.0	7.5
74	79	1.0	1.9	2.8	3.6	4.3	5.0	5.7	6.3	6.8	7.3
75	80	1.0	1.9	2.7	3.5	4.3	5.0	5.6	6.2	6.7	7.1
76	81	1.0	1.9	2.7	3.5	4.2	4.9	5.5	6.1	6.5	7.0
77	82	1.0	1.9	2.7	3.5	4.2	4.8	5.4	5.9	6.4	6.8
78	83	1.0	1.9	2.7	3.4	4.1	4.7	5.3	5.8	6.2	6.6
79	84	1.0	1.8	2.7	3.4	4.1	4.7	5.2	5.7	6.1	6.4
80	85	1.0	1.8	2.6	3.4	4.0	4.6	5.1	5.5	5.9	6.2
81	86	1.0	1.8	2.6	3.3	3.9	4.5	5.0	5.4	5.7	6.0
82	87	1.0	1.8	2.6	3.3	3.9	4.4	4.8	5.2	5.6	5.8
83	88	.9	1.8	2.6	3.2	3.8	4.3	4.7	5.1	5.4	5.6
84	89	.9	1.8	2.5	3.2	3.7	4.2	4.6	4.9	5.2	5.4
85	90	.9	1.8	2.5	3.1	3.6	4.1	4.5	4.8	5.0	5.2
86	91	.9	1.8	2.5	3.1	3.6	4.0	4.3	4.6	4.8	5.0

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	11	12	13	14	15	16	17	18	19	20
0 to 8	0 to 13	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
9	14	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
10	15	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
11	16	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
12	17	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
13	18	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
14	19	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
15	20	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.7	19.7
16	21	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
17	22	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
18	23	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
19	24	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
20	25	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
21	26	10.9	11.9	12.9	13.8	14.8	15.8	16.8	17.7	18.7	19.6
22	27	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
23	28	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
24	29	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.6	19.6
25	30	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.7	18.6	19.6
26	31	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
27	32	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
28	33	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.5
29	34	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.4
30	35	10.9	11.8	12.8	13.7	14.7	15.6	16.6	17.5	18.4	19.4
31	36	10.8	11.8	12.8	13.7	14.7	15.6	16.5	17.5	18.4	19.3
32	37	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.4	19.3
33	38	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.3	19.2
34	39	10.8	11.8	12.7	13.6	14.6	15.5	16.4	17.4	18.3	19.2
35	40	10.8	11.7	12.7	13.6	14.6	15.5	16.4	17.3	18.2	19.1
36	41	10.8	11.7	12.7	13.6	14.5	15.4	16.3	17.2	18.1	19.0
37	42	10.8	11.7	12.6	13.6	14.5	15.4	16.3	17.2	18.1	18.9
38	43	10.7	11.7	12.6	13.5	14.4	15.3	16.2	17.1	18.0	18.9
39	44	10.7	11.6	12.6	13.5	14.4	15.3	16.2	17.1	17.9	18.8
40	45	10.7	11.6	12.5	13.5	14.4	15.2	16.1	17.0	17.8	18.7
41	46	10.7	11.6	12.5	13.4	14.3	15.2	16.1	16.9	17.8	18.6
42	47	10.6	11.6	12.5	13.4	14.3	15.1	16.0	16.8	17.7	18.5
43	48	10.6	11.5	12.4	13.3	14.2	15.1	15.9	16.7	17.6	18.4
44	49	10.6	11.5	12.4	13.3	14.1	15.0	15.8	16.7	17.5	18.3
45	50	10.5	11.4	12.3	13.2	14.1	14.9	15.7	16.6	17.4	18.1

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of § 1.72–5.

TABLE IV—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	11	12	13	14	15	16	17	18	19	20
46	51	10.5	11.4	12.3	13.2	14.0	14.8	15.7	16.5	17.2	18.0
47	52	10.5	11.4	12.2	13.1	13.9	14.7	15.6	16.3	17.1	17.8
48	53	10.4	11.3	12.2	13.0	13.8	14.7	15.4	16.2	17.0	17.7
49	54	10.4	11.3	12.1	12.9	13.8	14.6	15.3	16.1	16.8	17.5
50	55	10.3	11.2	12.0	12.9	13.7	14.5	15.2	16.0	16.7	17.4
51	56	10.3	11.1	12.0	12.8	13.6	14.3	15.1	15.8	16.5	17.2
52	57	10.2	11.1	11.9	12.7	13.5	14.2	14.9	15.6	16.3	17.0
53	58	10.2	11.0	11.8	12.6	13.4	14.1	14.8	15.5	16.1	16.8
54	59	10.1	10.9	11.7	12.5	13.2	14.0	14.6	15.3	15.9	16.5
55	60	10.1	10.9	11.6	12.4	13.1	13.8	14.5	15.1	15.7	16.3
56	61	10.0	10.8	11.5	12.3	13.0	13.7	14.3	14.9	15.5	16.1
57	62	9.9	10.7	11.4	12.2	12.8	13.5	14.1	14.7	15.3	15.8
58	63	9.8	10.6	11.3	12.0	12.7	13.3	13.9	14.5	15.0	15.5
59	64	9.8	10.5	11.2	11.9	12.5	13.2	13.7	14.3	14.8	15.3
60	65	9.7	10.4	11.1	11.7	12.4	13.0	13.5	14.0	14.5	15.0
61	66	9.6	10.3	11.0	11.6	12.2	12.8	13.3	13.8	14.2	14.7
62	67	9.5	10.2	10.8	11.4	12.0	12.5	13.1	13.5	14.0	14.3
63	68	9.4	10.0	10.7	11.3	11.8	12.3	12.8	13.2	13.7	14.0
64	69	9.3	9.9	10.5	11.1	11.6	12.1	12.5	13.0	13.3	13.7
65	70	9.1	9.8	10.3	10.9	11.4	11.9	12.3	12.7	13.0	13.3
66	71	9.0	9.6	10.2	10.7	11.2	11.6	12.0	12.4	12.7	13.0
67	72	8.9	9.5	10.0	10.5	10.9	11.3	11.7	12.0	12.3	12.6
68	73	8.7	9.3	9.8	10.3	10.7	11.1	11.4	11.7	12.0	12.2
69	74	8.6	9.1	9.6	10.0	10.4	10.8	11.1	11.4	11.6	11.8
70	75	8.4	8.9	9.4	9.8	10.2	10.5	10.8	11.0	11.2	11.4
71	76	8.3	8.7	9.2	9.6	9.9	10.2	10.4	10.7	10.9	11.0
72	77	8.1	8.6	8.9	9.3	9.6	9.9	10.1	10.3	10.5	10.6
73	78	7.9	8.3	8.7	9.0	9.3	9.6	9.8	9.9	10.1	10.2
74	79	7.7	8.1	8.5	8.8	9.0	9.2	9.4	9.6	9.7	9.8
75	80	7.6	7.9	8.2	8.5	8.7	8.9	9.1	9.2	9.3	9.4
76	81	7.4	7.7	8.0	8.2	8.4	8.6	8.7	8.8	8.9	9.0
77	82	7.1	7.5	7.7	7.9	8.1	8.3	8.4	8.5	8.5	8.6
78	83	6.9	7.2	7.4	7.6	7.8	7.9	8.0	8.1	8.2	8.2
79	84	6.7	7.0	7.2	7.3	7.5	7.6	7.7	7.7	7.8	7.8
80	85	6.5	6.7	6.9	7.1	7.2	7.3	7.3	7.4	7.4	7.4
81	86	6.3	6.5	6.6	6.8	6.9	6.9	7.0	7.0	7.1	---
82	87	6.0	6.2	6.4	6.5	6.5	6.6	6.7	6.7	---	---
83	88	5.8	6.0	6.1	6.2	6.2	6.3	6.3	---	---	---
84	89	5.6	5.7	5.8	5.9	5.9	6.0	---	---	---	---
85	90	5.3	5.5	5.5	5.6	5.6	---	---	---	---	---
86	91	5.1	5.2	5.3	5.3	---	---	---	---	---	---

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	21	22	23	24	25	26	27	28	29	30
0 to 8	0 to 13	20.7	21.7	22.7	23.6	24.6	25.6	26.5	27.5	28.4	29.4
9	14	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
10	15	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
11	16	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
12	17	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
13	18	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
14	19	20.7	21.7	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.3
15	20	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.2
16	21	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.3	28.3	29.2
17	22	20.7	21.6	22.6	23.5	24.5	25.4	26.4	27.3	28.2	29.2
18	23	20.7	21.6	22.6	23.5	24.5	25.4	26.3	27.3	28.2	29.1
19	24	20.6	21.6	22.5	23.5	24.4	25.4	26.3	27.2	28.1	29.1
20	25	20.6	21.6	22.5	23.5	24.4	25.3	26.3	27.2	28.1	29.0

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of § 1.72–5.

TABLE IV—TEMPORARY LIFE ANNUITIES [1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	21	22	23	24	25	26	27	28	29	30
21	26	20.6	21.5	22.5	23.4	24.4	25.3	26.2	27.1	28.0	28.9
22	27	20.6	21.5	22.5	23.4	24.3	25.3	26.2	27.1	28.0	28.9
23	28	20.6	21.5	22.4	23.4	24.3	25.2	26.1	27.0	27.9	28.8
24	29	20.5	21.5	22.4	23.3	24.2	25.2	26.1	27.0	27.8	28.7
25	30	20.5	21.4	22.4	23.3	24.2	25.1	26.0	26.9	27.8	28.6
26	31	20.5	21.4	22.3	23.2	24.1	25.0	25.9	26.8	27.7	28.5
27	32	20.4	21.3	22.3	23.2	24.1	25.0	25.8	26.7	27.6	28.4
28	33	20.4	21.3	22.2	23.1	24.0	24.9	25.8	26.6	27.5	28.3
29	34	20.3	21.2	22.1	23.0	23.9	24.8	25.7	26.5	27.4	28.2
30	35	20.3	21.2	22.1	23.0	23.8	24.7	25.6	26.4	27.2	28.1
31	36	20.2	21.1	22.0	22.9	23.8	24.6	25.5	26.3	27.1	27.6
32	37	20.2	21.1	21.9	22.8	23.7	24.5	25.4	26.2	27.0	27.8
33	38	20.1	21.0	21.9	22.7	23.6	24.4	25.2	26.0	26.8	27.6
34	39	20.0	20.9	21.8	22.6	23.5	24.3	25.1	25.9	26.7	27.4
35	40	20.0	20.8	21.7	22.5	23.3	24.2	25.0	25.7	26.5	27.2
36	41	19.9	20.7	21.6	22.4	23.2	24.0	24.8	25.6	26.3	27.0
37	42	19.8	20.6	21.5	22.3	23.1	23.9	24.6	25.4	26.1	26.8
38	43	19.7	20.5	21.4	22.2	23.0	23.7	24.5	25.2	25.9	26.6
39	44	19.6	20.4	21.2	22.0	22.8	23.6	24.3	25.0	25.7	26.4
40	45	19.5	20.3	21.1	21.9	22.6	23.4	24.1	24.8	25.5	26.1
41	46	19.4	20.2	21.0	21.7	22.5	23.2	23.9	24.6	25.2	25.9
42	47	19.3	20.1	20.8	21.6	22.3	23.0	23.7	24.3	25.0	25.6
43	48	19.2	19.9	20.7	21.4	22.1	22.8	23.4	24.1	24.7	25.3
44	49	19.0	19.8	20.5	21.2	21.9	22.6	23.2	23.8	24.4	25.0
45	50	18.9	19.6	20.3	21.0	21.7	22.3	22.9	23.5	24.1	24.6
46	51	18.7	19.4	20.1	20.8	21.5	22.1	22.7	23.2	23.8	24.3
47	52	18.6	19.3	19.9	20.6	21.2	21.8	22.4	22.9	23.4	23.9
48	53	18.4	19.1	19.7	20.4	21.0	21.5	22.1	22.6	23.1	23.5
49	54	18.2	18.9	19.5	20.1	20.7	21.2	21.7	22.2	22.7	23.1
50	55	18.0	18.7	19.3	19.8	20.4	20.9	21.4	21.9	22.3	22.7
51	56	17.8	18.4	19.0	19.6	20.1	20.6	21.1	21.5	21.9	22.3
52	57	17.6	18.2	18.7	19.3	19.8	20.2	20.7	21.1	21.5	21.8
53	58	17.4	17.9	18.5	19.0	19.4	19.9	20.3	20.7	21.0	21.3
54	59	17.1	17.7	18.2	18.7	19.1	19.5	19.9	20.2	20.6	20.8
55	60	16.9	17.4	17.9	18.3	18.7	19.1	19.5	19.8	20.1	20.3
56	61	16.6	17.1	17.5	18.0	18.4	18.7	19.0	19.3	19.6	19.8
57	62	16.3	16.8	17.2	17.6	18.0	18.3	18.6	18.9	19.1	19.3
58	63	1°.0	16.5	16.9	17.2	17.6	17.9	18.1	18.4	18.6	18.8
59	64	15.7	16.1	16.5	16.8	17.1	17.4	17.7	17.9	18.1	18.2
60	65	15.4	15.8	16.1	16.4	16.7	17.0	17.2	17.4	17.5	17.7
61	66	15.1	15.4	15.7	16.0	16.3	16.5	16.7	16.9	17.0	17.1
62	67	14.7	15.0	15.3	15.6	15.8	16.0	16.2	16.3	16.4	16.5
63	68	14.4	14.6	14.9	15.1	15.3	15.5	15.7	15.8	15.9	16.0
64	69	14.0	14.3	14.5	14.7	14.9	15.0	15.2	15.3	15.3	15.4
65	70	13.6	13.8	14.1	14.2	14.4	14.5	14.6	14.7	14.8	14.9
66	71	13.2	13.4	13.6	13.8	13.9	14.0	14.1	14.2	14.2	14.3
67	72	12.8	13.0	13.2	13.3	13.4	13.5	13.6	13.7	13.7	13.7
68	73	12.4	12.6	12.7	12.8	12.9	13.0	13.1	13.1	13.2	13.2
69	74	12.0	12.1	12.3	12.4	12.4	12.5	12.6	12.6	12.6	12.6
70	75	11.6	11.7	11.8	11.9	12.0	12.0	12.0	12.1	12.1	12.1
71	76	11.2	11.3	11.3	11.4	11.5	11.5	11.5	11.6	11.6	---
72	77	10.7	10.8	10.9	10.9	11.0	11.0	11.0	11.0	---	---
73	78	10.3	10.4	10.4	10.5	10.5	10.5	10.5	---	---	---
74	79	9.9	9.9	10.0	10.0	10.1	10.1	---	---	---	---
75	80	9.5	9.5	9.6	9.6	9.6	---	---	---	---	---
76	81	9.1	9.1	9.1	9.1	---	---	---	---	---	---
77	82	8.6	8.7	8.7	---	---	---	---	---	---	---
78	83	8.2	8.3	---	---	---	---	---	---	---	---
79	84	7.8	---	---	---	---	---	---	---	---	---

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases see paragraph (c) of § 1.72–5.

If the terms of the contract (a) involve a life or lives, (b) are such that the above tables cannot be correctly applied, and (c) the amounts received thereunder are at least partly "amounts received as an annuity" under a contract to which section 72 applies, the taxpayer may submit with his return an actuarial computation based upon the 1937 Standard Annuity Table with ages set back one year, showing the appropriate factors applied in his case, subject to the approval of the Commissioner upon examination of such return. Computations involving factors to compensate for the effects of contingencies other than mortality, such as marriage or remarriage, re-employment, recovery from disability, or the like, will not be approved.

§ 1.72–10 Effect of transfer of contracts on investment in the contract.

(a) If a contract to which section 72 applies, or any interest therein, is transferred for a valuable consideration, by assignment or otherwise, only the actual value of the consideration given for such transfer and the amount of premiums or other consideration subsequently paid by the transferee shall be included in the transferee's aggregate of premiums or other consideration paid. In accordance with the provisions of section 72 (g) (3) and paragraph (b) of § 1.72–4, an annuity starting date shall be determined for the transferee without regard to the annuity starting date, if any, of the transferor. In determining the transferee's investment in the contract, the aggregate amount of premiums or other consideration paid shall be reduced by all amounts received by the transferee before the receipt of an amount as an annuity or before the annuity starting date, whichever is the later, to the extent that such amounts were excludable from his gross income under the applicable income tax law at the time of receipt. For the treatment of amounts received by the transferee subsequent to both the annuity starting date and the date of receipt of a payment as an annuity, but not received as annuity payments, see § 1.72–11. For a limitation on adjustments to the basis of annuity contracts sold, see section 1021.

(b) In the case of a transfer of such a contract without valuable consideration, the annuity starting date and the expected return under the contract shall be determined as though no such transfer had taken place. See paragraph (b) of § 1.72–4. The transferee shall include the aggregate of premiums or other consideration paid or deemed to have been paid by his transferor in the aggregate of premiums or other consideration as though paid by him. In determining the transferee's investment in the contract, the transferee's aggregate amount of premiums or other consideration paid (as so found) shall be reduced by all amounts either received or deemed to have been received by himself or his transferor before the annuity starting date, or before the date on which an amount is first received as an annuity, whichever is the later, to the extent that such amounts were excludable from the gross income of the actual recipient under the applicable income tax law at the time of receipt. For treatment of amounts received subsequent to both the above dates by such transferee, but not received as annuity payments, see § 1.72–11.

§ 1.72–11 Amounts not received as annuity payments.

(a) *Introductory.* (1) This section applies to amounts received under a contract to which section 72 applies if either:

(i) Paragraph (b) of § 1.72–2 is inapplicable to such amounts.

(ii) Paragraph (b) of § 1.72–2 is applicable but the annuity payments received differ either in amount, duration, or both, from those originally provided under the contract, or

(iii) Paragraph (b) of § 1.72 is applicable, but such annuity payments are received by a beneficiary after the death of an annuitant (or annuitants) in full discharge of the obligation under the contract and solely because of a guarantee.

The payments referred to in subdivision (i) of this subparagraph include all amounts other than "amounts received as an annuity" as that term is defined in paragraph (b) (2) and (3) of § 1.72–2. If such amounts are received as dividends or payments in the nature of dividends, or as a return of premiums, see paragraph (b) of this section. If such amounts are paid in full discharge of the obligation under the contract and are in the nature of a refund of the consideration, see paragraph (c) of this section. If such amounts are paid upon the surrender, redemption, or maturity of the contract, see paragraph (d) of this section. The payments referred to in subdivision (ii) of this subparagraph include all annuity payments which are paid as the result of a modification or an exchange of the annuity obligations originally provided under a contract for different annuity obligations (whether or not such modification or exchange is accompanied by the payment of an amount to which subdivision (i) of this subparagraph applies). If the duration of the new annuity obligations differs from the duration of the old annuity obligations, paragraph (e) of this section applies to the new annuity obligations and paragraph (d) of this section applies to any lump sum payment received. If, however, the duration of the new annuity obligations is the same as the duration of the old obligations, paragraph (f) of this section applies to the new obligations and to any lump sum received in connection therewith. The annuity payments referred to in subdivision (iii) of this subparagraph are annuity payments which are made to a beneficiary after the death of annuitant (or annuitants) in full discharge of the obligations under a contract because of a provision in the contract requiring the payment of a guaranteed amount or minimum number of payments for a fixed period; see paragraph (c) of this section.

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except section 72 (e) (3)) in accordance with sections 402 and 403 and the regulations thereunder. The principles of this section also apply to payments made in the manner described in paragraph (b) (3) (i) of § 1.72–2.

(b) *Amounts received in the nature of dividends or similar distributions.* (1) If dividends (or payments in the nature of dividends or a return of premiums or other consideration) are received under a contract to which section 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity, whichever is the later, such payments are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the recipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Such payments shall also be subtracted from the consideration paid (or deemed paid) both for the purpose of determining an exclusion ratio to be applied to subsequent amounts paid as an annuity and for the purpose of determining the applicability of section 72 (d) and § 1.72–13, relating to employee contributions recoverable in three years.

(2) If dividends or payments in the nature of dividends are paid under a contract to which section 72 applies and such payments are received on or after the annuity starting date or the date on which an amount is first received as an annuity, whichever is later, such payments shall be fully includible in the gross income of the recipient. The receipt of such payments shall not affect the aggregate of premiums or other consideration paid nor the amounts contributed or deemed to have been contributed by an employee as otherwise calculated for purposes of section 72. Since the investment in the contract and the expected return are not affected by a payment which is fully includible in the gross income of the recipient under this rule, the exclusion ratio will not be affected by such payment and will continue to be applied to amounts received as annuity payments in the future as though such payment had not been made. This subparagraph shall apply to amounts received under a contract described in paragraph (b) (3) (i) of § 1.72–2 to the extent that the amounts received exceed the portion of the investment in the contract allocable to each taxable year in accordance with paragraph (d) (3) of § 1.72–4. Hence, such excess is fully includible in the gross income of the recipient.

(c) *Amounts received in the nature of a refund of the consideration under a contract and in full discharge of the obligation thereof.* (1) Any amount received under a contract to which section 72 applies, if it is at least in part a refund of the consideration paid, including amounts payable to a beneficiary after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain or with a minimum amount which must be paid in any event,

shall be considered an amount received in the nature of a refund of the consideration paid for such contract. If such an amount is in full discharge of an obligation to pay a fixed amount (whether in a lump sum or otherwise) or to pay amounts for a fixed number of years (including amounts described in paragraph (b) (3) (i) of § 1.72–2), it shall be included in the gross income of the recipient only to the extent that it, when added to amounts previously received under the contract which were excludable from gross income under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72 (e) (2) (A). This paragraph shall not apply if the total of the amounts to be paid in discharge of the obligation can in any event exceed the total of the annuity payments which would otherwise fully discharge the obligation. For rules to be applied in such a case, see paragraph (e) of this section.

(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A, a male employee, retired on December 31, 1954, at the age of 60. A life annuity of $75 per month was payable to him beginning January 31, 1955. The annuity contract guaranteed that if A did not live at least ten years, his beneficiary, B, would receive the monthly payments for any balance of the first ten years after A's retirement which remained at the date of A's death. Under section 72, A was deemed to have paid $3,600 toward the cost of the annuity. A lived for five years, receiving a total of $4,500 in annuity payments. After A's death, B began receiving the monthly payments of $75 beginning with the January 31, 1960, payment. B will exclude such payments from his gross income throughout 1960, 1961, and 1962, and will exclude only $18 of the first payment in 1963 from his gross income for that year. Thereafter, B will include the entire amount of all such payments in his gross income for the taxable year of receipt. This result is determined as follows:

A's investment in the contract (unadjusted)	$3,600
Multiple from Table III of § 1.72–9 for male, age 60, where duration of guaranteed amount is 10 years (percent)	11
Subtract value of the refund feature to the nearest dollar (11 percent of $3,600)	396
Investment in the contract adjusted for the present value of the refund feature without discount for interest	$3,204
Aggregate of premiums or other consideration paid	3,600
A's exclusion ratio ($3,204÷$16,380 [$900×18.2]) (percent)	19.6
Subtract amount excludable during five years A received payments (19.6 percent of $4,500 [$900×5])	882
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72 (e)	2,718

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 36$\frac{2}{5}$ ($2,718÷$75) and B will exclude the payments from his gross income for three years, then exclude only $18 of the first payment for the fourth year from his gross income, and thereafter include the entire amount of all payments he receives in his gross income.

Example (2). The facts are the same as in example (1), except that B, the beneficiary, elects to receive $50 per month for his life in lieu of the payments guaranteed under the original contractual obligation. Since such amounts will be received as an annuity and may, because of the length of time B may live, exceed the amount guaranteed, they are not amounts to which this paragraph applies. See paragraph (e) of this section.

Example (3). The facts are the same as in example (1), except that B, the beneficiary, elects to receive the remaining guaranteed amount in installments which are larger or smaller than the $75 per month provided until, under the terms of the contract, the guaranteed amount is exhausted. The rule of subparagraph (1) of this paragraph and the computation illustrated in example (1) apply to such installments since the total of such installments will not exceed the original amount guaranteed to be paid at A's death in any event.

Example (4). C pays $12,000 for a contract providing that he is to be paid an annuity of $1,000 per year for 15 years. His exclusion ratio is therefore 80 percent ($12,000÷$15,000). He directs that the annuity is to be paid to D, his beneficiary, if he should die before the full 15 year period has expired. C dies after 5 years and D is paid $1,000 in 1960. D will include $200 ($1,000—$800 [80 percent of $1,000]) in his gross income for the taxable year in which he receives the $1,000 since section 72 (e) and this section do not apply to the annuity payments made in accordance with the provisions and during the term of the contract. D will continue with the same exclusion ratio used by C (80 percent).

Example (5). In 1954, E paid $50,000 into a fund and was promised an annual income for life the amount of which would depend in part upon the earnings realized from the investment of the fund in accordance with an agreed formula. The contract also specified that if E should die before ten years had elapsed, his beneficiary, F, would be paid the amounts determined annually under the formula until ten payments had been realized by E and F together. E died in 1960, having received five payments totalling $30,000. Assuming that $22,000 of this amount was properly excludable from E's gross income prior to his death, F will exclude from his gross income the payments he receives until the taxable year in which his total receipts from the fund exceeds $28,000 ($50,000—$22,000). F will include any excess over the $28,000 in his gross income for that taxable year. Thereafter, F will include in his gross income the entire amount of any payments made to him from the fund.

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the tax attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.* (1) Any amount received upon the surrender, redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the regulations of paragraph (b) of § 1.72–2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludable from the gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72 (e) (2) (B). If amounts are to be received as an annuity, whether in lieu of or in addition to amounts described in the preceding sentence, such amounts shall be included in the gross income of the recipient in accordance with the provisions of paragraph (e) or (f) of this section, whichever is applicable. The rule stated in the first sentence of this paragraph shall not apply to payments received as an annuity or otherwise after the date of the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the original contract. If amounts are so received and are other than amounts received as an annuity, they are includible in the gross income of the recipient. See section 72 (e) (1) (A) and paragraph (b) (2) of this section.

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the amount of tax attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

(e) *Periodic payments received for a different term.* If, after the date on which an amount is first received as an annuity under a contract to which section 72 applies, the terms of the contract are modified or the annuity obligations are exchanged so that periodic payments are to be received for a different term than originally provided under the contract (whether or not accompanied by the receipt of a lump sum to which paragraph (d) of this section applies), the rules of this paragraph shall apply to such payments. Hence, the provisions of section 72 (e) and paragraphs (b), (c), (d), and (f) of this section are inapplicable for the purpose of determining the includibility of such payments in gross income and the general principles of section 72 with respect to the use of an exclusion ratio shall be applied to such payments as if they were provided under a new contract received in exchange for the contract providing the original annuity payments. If such payments are received as the result of the surrender, redemption, or discharge of a contract to which section 72 applies, they shall be considered to be received as an annuity under a contract ex-

changed for the contract whose redemption, surrender, or discharge was involved. For the purpose of determining the extent to which the payments so received are to be included in the gross income of the recipient, an exclusion ratio shall be determined for such contract as of the later of January 1, 1954, or the first day of the first period for which an amount is received as an annuity thereunder, whichever is the later. See paragraph (b) of § 1.72–4. In determining the investment in the contract for this purpose, any lump sum amount received at the time of the exchange shall not be considered an amount to which paragraph (a) (2) of § 1.72–6 applies. However, such lump sum shall be subtracted from the aggregate of premiums or other consideration paid to the extent it is excludable as an amount not received as an annuity under this section as if it were an amount received before the annuity starting date of the contract obtained in exchange.

(f) *Periodic payments received for the same term after a lump sum withdrawal.* (1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 applies, the tax attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72 (e) (3) and paragraph (g) of this section.

(2) There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from the gross income of the recipient under the applicable income tax law, as:

(i) In the case of payments to be made in the manner described in paragraph (b) (2) of § 1.72–2, the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract, or

(ii) In the case of a contract providing for payments to be made in the manner described in paragraph (b) (3) (i) of § 1.72–2, the amount of the reduction in the number of units per period to be paid thereafter bears to the number of units per period payable under the contract immediately before the lump sum withdrawal.

(3) This paragraph may be illustrated by the following examples:

Example (1). Taxpayer A pays $20,000 for an annuity contract providing for payments to him of $100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore $24,000 and the exclusion ratio is five-sixth. He continues to receive the original annuity payments for five years, receiving a total of $6,000, and properly excludes a total of $5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of $75 per month and a lump sum payment of $4,000 in cash. Of the lump sum he receives, he will include $250 and exclude $3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid	$20,000
Less amounts received as an annuity to the extent they were excludable from A's income	5,000
Remainder of the consideration	15,000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments ($25/$100)	¼
Lump sum received	$4,000
Less one-fourth of the remainder of the consideration (¼ of $15,000)	3,750
Portion of the lump sum includible in gross income (to which the limit on tax of section 72 (e) (3) applies)	250

If, in this example, the annuity were a pension payable to A as a retired employee, but the facts were otherwise the same (assuming that, for instance, the $20,000 aggregate of premiums or other consideration paid were A's contributions as determined under section 72 (f) and § 1.72–8) the result would be the same except that the tax attributable to the inclusion of the $250 in A's gross income would not be limited by section 72 (e) (3).

Example (2). Taxpayer B pays $30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives $12,000 during the first five years of participation and of this amount he has properly excluded a total of $10,000 from his gross income in his income returns for the taxable years, since $2,000 of $2,400 he received in each such year represented his investment divided by the term of the annuity ($30,000÷15). At the beginning of the sixth year, B agrees to take $11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining ten years of payments in full discharge of the original obligations of the contract. B shall include $1,000 in his gross income for the sixth year as the result of the lump sum he receives and allocates $1,000 of his original investment in the contract to each of the remaining ten years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid	$30,000
Total amount received and excludable from gross income	10,000
Remainder of the consideration	20,000
Ratio of units discontinued to the total units originally provided	5/10, or ½
Lump sum received at the time of reduction in the number of units to be paid	$11,000
Less one-half of the remainder of the consideration (½ of $20,000)	10,000
Portion of the lump sum received and includible in gross income (to which the provisions of section 72 (e) (3) applies in this case)	1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum ($20,000—$10,000)	$10,000
Remainder of the consideration properly allocable to each taxable year for the remaining ten years ($10,000÷10)	1,000

(g) *Limit on tax attributable to the receipt of a lump sum.* If the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the two preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of:

(1) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(2) The difference between the total amount of tax for the taxable year of receipt and the two preceding taxable years computed by including one-third of such portion in gross income for each of the three taxable years, and the total amount of the tax for the taxable year of receipt and the two preceding taxable years computed by entirely excluding such portion from the gross income of all three taxable years.

For the definition of "taxable year", see section 441 (b). This paragraph shall not apply to payments excepted from the application of section 72 (e) (3) under the provisions of section 402 or 403. See paragraph (a) of § 1.72–2 and paragraph (d) of § 1.72–14.

(h) *Amounts deemed to be paid or received by a transferee.* Amounts deemed to have been paid or received by a transferee for the purposes of § 1.72–10 shall also be deemed to have been so paid or received by such transferee for the purposes of this section. Thus, if a donee is deemed to have paid the premiums or other consideration actually paid by his transferor for the purposes of section 72 (g) and paragraph (b) of § 1.72–10, such consideration shall be deemed premiums or other consideration paid by the donee for the purposes of this section.

§ 1.72–12 Effect of taking an annuity in lieu of a lump sum upon the maturity of a contract.

If a contract to which section 72 applies provides for the payment of a lump sum in full discharge of the obligation thereunder and the obligee entitled thereto, prior to receiving any portion of such lump sum and within 60 days

shall be considered an amount received in the nature of a refund of the consideration paid for such contract. If such an amount is in full discharge of an obligation to pay a fixed amount (whether in a lump sum or otherwise) or to pay amounts for a fixed number of years (including amounts described in paragraph (b) (3) (i) of § 1.72–2), it shall be included in the gross income of the recipient only to the extent that it, when added to amounts previously received under the contract which were excludable from gross income under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72 (e) (2) (A). This paragraph shall not apply if the total of the amounts to be paid in discharge of the obligation can in any event exceed the total of the annuity payments which would otherwise fully discharge the obligation. For rules to be applied in such a case, see paragraph (e) of this section.

(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A, a male employee, retired on December 31, 1954, at the age of 60. A life annuity of $75 per month was payable to him beginning January 31, 1955. The annuity contract guaranteed that if A did not live at least ten years, his beneficiary, B, would receive the monthly payments for any balance of the first ten years after A's retirement which remained at the date of A's death. Under section 72, A was deemed to have paid $3,600 toward the cost of the annuity. A lived for five years, receiving a total of $4,500 in annuity payments. After A's death, B began receiving the monthly payments of $75 beginning with the January 31, 1960, payment. B will exclude such payments from his gross income throughout 1960, 1961, and 1962, and will exclude only $18 of the first payment in 1963 from his gross income for that year. Thereafter, B will include the entire amount of all such payments in his gross income for the taxable year of receipt. This result is determined as follows:

A's investment in the contract (unadjusted)	$3,600
Multiple from Table III of § 1.72–9 for male, age 60, where duration of guaranteed amount is 10 years (percent)	11
Subtract value of the refund feature to the nearest dollar (11 percent of $3,600)	396
Investment in the contract adjusted for the present value of the refund feature without discount for interest	$3,204
Aggregate of premiums or other consideration paid	3,600
A's exclusion ratio ($3,204÷$16,380 [$900×18.2]) (percent)	19.6
Subtract amount excludable during five years A received payments (19.6 percent of $4,500 [$900×5])	882
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72 (e)	2,718

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 36⅔ ($2,718÷$75) and B will exclude the payments from his gross income for three years, then exclude only $18 of the first payment for the fourth year from his gross income, and thereafter include the entire amount of all payments he receives in his gross income.

Example (2). The facts are the same as in example (1), except that B, the beneficiary, elects to receive $50 per month for his life in lieu of the payments guaranteed under the original contractual obligation. Since such amounts will be received as an annuity and may, because of the length of time B may live, exceed the amount guaranteed, they are not amounts to which this paragraph applies. See paragraph (e) of this section.

Example (3). The facts are the same as in example (1), except that B, the beneficiary, elects to receive the remaining guaranteed amount in installments which are larger or smaller than the $75 per month provided until, under the terms of the contract, the guaranteed amount is exhausted. The rule of subparagraph (1) of this paragraph and the computation illustrated in example (1) apply to such installments since the total of such installments will not exceed the original amount guaranteed to be paid at A's death in any event.

Example (4). C pays $12,000 for a contract providing that he is to be paid an annuity of $1,000 per year for 15 years. His exclusion ratio is therefore 80 percent ($12,000÷$15,000). He directs that the annuity is to be paid to D, his beneficiary, if he should die before the full 15 year period has expired. C dies after 5 years and D is paid $1,000 in 1960. D will include $200 ($1,000−$800 [80 percent of $1,000]) in his gross income for the taxable year in which he receives the $1,000 since section 72 (e) and this section do not apply to the annuity payments made in accordance with the provisions and during the term of the contract. D will continue with the same exclusion ratio used by C (80 percent).

Example (5). In 1954, E paid $50,000 into a fund and was promised an annual income for life the amount of which would depend in part upon the earnings realized from the investment of the fund in accordance with an agreed formula. The contract also specified that if E should die before ten years had elapsed, his beneficiary, F, would be paid the amounts determined annually under the formula until ten payments had been realized by E and F together. E died in 1960, having received five payments totalling $30,000. Assuming that $22,000 of this amount was properly excludable from E's gross income prior to his death, F will exclude from his gross income the payments he receives until the taxable year in which his total receipts from the fund exceeds $28,000 ($50,000−$22,000). F will include any excess over the $28,000 in his gross income for that taxable year. Thereafter, F will include in his gross income the entire amount of any payments made to him from the fund.

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the tax attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.* (1) Any amount received upon the surrender, redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the regulations of paragraph (b) of § 1.72–2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludable from the gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72 (e) (2) (B). If amounts are to be received as an annuity, whether in lieu of or in addition to amounts described in the preceding sentence, such amounts shall be included in the gross income of the recipient in accordance with the provisions of paragraph (e) or (f) of this section, whichever is applicable. The rule stated in the first sentence of this paragraph shall not apply to payments received as an annuity or otherwise after the date of the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the original contract. If amounts are so received and are other than amounts received as an annuity, they are includible in the gross income of the recipient. See section 72 (e) (1) (A) and paragraph (b) (2) of this section.

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the amount of tax attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

(e) *Periodic payments received for a different term.* If, after the date on which an amount is first received as an annuity under a contract to which section 72 applies, the terms of the contract are modified or the annuity obligations are exchanged so that periodic payments are to be received for a different term than originally provided under the contract (whether or not accompanied by the receipt of a lump sum to which paragraph (d) of this section applies), the rules of this paragraph shall apply to such payments. Hence, the provisions of section 72 (e) and paragraphs (b), (c), (d), and (f) of this section are inapplicable for the purpose of determining the includibility of such payments in gross income and the general principles of section 72 with respect to the use of an exclusion ratio shall be applied to such payments as if they were provided under a new contract received in exchange for the contract providing the original annuity payments. If such payments are received as the result of the surrender, redemption, or discharge of a contract to which section 72 applies, they shall be considered to be received as an annuity under a contract ex-

changed for the contract whose redemption, surrender, or discharge was involved. For the purpose of determining the extent to which the payments so received are to be included in the gross income of the recipient, an exclusion ratio shall be determined for such contract as of the later of January 1, 1954, or the first day of the first period for which an amount is received as an annuity thereunder, whichever is the later. See paragraph (b) of § 1.72–4. In determining the investment in the contract for this purpose, any lump sum amount received at the time of the exchange shall not be considered an amount to which paragraph (a) (2) of § 1.72–6 applies. However, such lump sum shall be subtracted from the aggregate of premiums or other consideration paid to the extent it is excludable as an amount not received as an annuity under this section as if it were an amount received before the annuity starting date of the contract obtained in exchange.

(f) *Periodic payments received for the same term after a lump sum withdrawal.* (1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 applies, the tax attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72 (e) (3) and paragraph (g) of this section.

(2) There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from the gross income of the recipient under the applicable income tax law, as:

(i) In the case of payments to be made in the manner described in paragraph (b) (2) of § 1.72–2, the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract, or

(ii) In the case of a contract providing for payments to be made in the manner described in paragraph (b) (3) (i) of § 1.72–2, the amount of the reduction in the number of units per period to be paid thereafter bears to the number of units per period payable under the contract immediately before the lump sum withdrawal.

(3) This paragraph may be illustrated by the following examples:

Example (1). Taxpayer A pays $20,000 for an annuity contract providing for payments to him of $100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore $24,000 and the exclusion ratio is five-sixth. He continues to receive the original annuity payments for five years, receiving a total of $6,000, and properly excludes a total of $5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of $75 per month and a lump sum payment of $4,000 in cash. Of the lump sum he receives, he will include $250 and exclude $3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid	$20,000
Less amounts received as an annuity to the extent they were excludable from A's income	5,000
Remainder of the consideration	15,000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments ($25/$100, or ¼)	
Lump sum received	$4,000
Less one-fourth of the remainder of the consideration (¼ of $15,000)	3,750
Portion of the lump sum includible in gross income (to which the limit on tax of section 72 (e) (3) applies)	250

If, in this example, the annuity were a pension payable to A as a retired employee, but the facts were otherwise the same (assuming that, for instance, the $20,000 aggregate of premiums or other consideration paid were A's contributions as determined under section 72 (*f*) and § 1.72–8) the result would be the same except that the tax attributable to the inclusion of the $250 in A's gross income would not be limited by section 72 (e) (3).

Example (2). Taxpayer B pays $30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives $12,000 during the first five years of participation and of this amount he has properly excluded a total of $10,000 from his gross income in his income returns for the taxable years, since $2,000 of $2,400 he received in each such year represented his investment divided by the term of the annuity ($30,000÷15). At the beginning of the sixth year, B agrees to take $11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining ten years of payments in full discharge of the original obligations of the contract. B shall include $1,000 in his gross income for the sixth year as the result of the lump sum he receives and allocates $1,000 of his original investment in the contract to each of the remaining ten years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid	$30,000
Total amount received and excludable from gross income	10,000
Remainder of the consideration	20,000
Ratio of units discontinued to the total units originally provided	5/10, or ½
Lump sum received at the time of reduction in the number of units to be paid	$11,000
Less one-half of the remainder of the consideration (½ of $20,000)	10,000
Portion of the lump sum received and includible in gross income (to which the provisions of section 72 (e) (3) applies in this case)	1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum ($20,000—$10,000)	$10,000
Remainder of the consideration properly allocable to each taxable year for the remaining ten years ($10,000÷10)	1,000

(g) *Limit on tax attributable to the receipt of a lump sum.* If the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the two preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of:

(1) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(2) The difference between the total amount of tax for the taxable year of receipt and the two preceding taxable years computed by including one-third of such portion in gross income for each of the three taxable years, and the total amount of the tax for the taxable year of receipt and the two preceding taxable years computed by entirely excluding such portion from the gross income of all three taxable years.

For the definition of "taxable year", see section 441 (b). This paragraph shall not apply to payments excepted from the application of section 72 (e) (3) under the provisions of section 402 or 403. See paragraph (a) of § 1.72–2 and paragraph (d) of § 1.72–14.

(h) *Amounts deemed to be paid or received by a transferee.* Amounts deemed to have been paid or received by a transferee for the purposes of § 1.72–10 shall also be deemed to have been so paid or received by such transferee for the purposes of this section. Thus, if a donee is deemed to have paid the premiums or other consideration actually paid by his transferor for the purposes of section 72 (g) and paragraph (b) of § 1.72–10, such consideration shall be deemed premiums or other consideration paid by the donee for the purposes of this section.

§ 1.72–12 Effect of taking an annuity in lieu of a lump sum upon the maturity of a contract.

If a contract to which section 72 applies provides for the payment of a lump sum in full discharge of the obligation thereunder and the obligee entitled thereto, prior to receiving any portion of such lump sum and within 60 days

after the date on which such lump sum first becomes payable, exercises an option or irrevocably agrees with the obligor to take, in lieu thereof, payments which will constitute "amounts received as an annuity", as that term is defined in paragraph (b) of § 1.72–2, no part of such lump sum shall be deemed to have been received by the obligee at the time he was first entitled thereto merely because he would have been entitled to such amount had he not exercised the option or made such an agreement with the obligor.

§ 1.72–13 Special rule for employee contributions recoverable in three years.

(a) *Amounts received as an annuity.* (1) Section 72(d) provides a special rule for the treatment of amounts received as an annuity by an employee (or by the beneficiary or beneficiaries of an employee) under a contract to which section 72 applies. This special rule is applicable only in the event that:

(i) At least part of the consideration paid for the contract is contributed by the employer, and

(ii) The aggregate amount receivable as an annuity under such contract by the employee (or by his beneficiary or beneficiaries if the employee died before any amount was received as an annuity under the contract) within the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received as an annuity equals or exceeds the total consideration contributed (or deemed contributed under section 72 (f) and § 1.72–8) by the employee as of such date as reduced by all amounts previously received and excludable from the gross income of the recipient under the applicable income tax law.

In such an event, section 72 (d) provides that all amounts received as an annuity under the contract during a taxable year to which the Code applies shall be excluded from gross income until the total of the amounts excluded under that section plus all amounts excluded under prior income tax laws equals or exceeds the consideration contributed (or deemed contributed) by the employee. The excess, if any, and all amounts received by any recipient thereafter (whether or not received as an annuity), shall be fully included in gross income. See paragraph (b) of this section.

(2) If the aggregate amount receivable as an annuity under the contract within three years from the date on which an amount is first received as an annuity thereunder will not equal or exceed the consideration contributed (or deemed contributed) by the employee in accordance with the provisions of § 1.72–8, computed as of such date, the special rule of section 72 (d) shall not apply to amounts received as an annuity under the contract and the general rules of section 72 shall apply thereto.

(3) The aggregate of the amounts receivable as an annuity within the prescribed 3-year period shall be the total of all annuity payments anticipatable by an employee (or a beneficiary or beneficiaries of an employee, if the employee died before any amount was received as whole as defined in paragraph (a) of § 1.72–2. However, as provided in paragraph (a) of § 1.72–2, the applicability of section 72 (d) and this section shall be determined separately with respect to each separate plan or trust in which the employee has an interest. For example, the applicability of this section and section 72 (d) to amounts received under a Civil Service Retirement annuity which is paid as the result of involuntary contributions of an employee shall be considered separately from the applicability of such sections to amounts received under such an annuity which is paid as the result of voluntary contributions of the employee.

(4) If subparagraphs (1) and (3) of this paragraph apply to amounts received as an annuity under a contract, the rule prescribed in subparagraph (1) of this paragraph shall apply to all amounts so received thereunder regardless of the fact that they may be payable (i) to more than one beneficiary, (ii) for the same or different intervals, (iii) in different sums, or (iv) for a different period certain, life, or lives.

(b) *Amounts not received as an annuity.* If the rule of paragraph (a) of this section applies to a contract and, after the date on which an annuity payment is first received, amounts are received other than as an annuity under such contract in a taxable year to which the Code applies, they shall be included in the gross income of the recipient in accordance with the provisions of § 1.72–11. Thus, if such amounts are received as a dividend or a similar distribution after the date on which an amount is first received as an annuity under the contract, they shall be included in the gross income of the recipient (in accordance with section 72 (e) (1) (A) and paragraph (b) (2) of § 1.72–11. All other amounts not received as an annuity shall be included in the gross income of the recipient in accordance with the provisions of section 72 (e) (1) (B) and paragraph (c), (d), or (f), whichever is applicable, of § 1.72–11. See section 72 (e) (2).

(c) *Amounts received after the exhaustion of employee contributions.* (1) Amounts received under a contract to which the rule of paragraph (a) of this section applies (whether or not such amounts are received as an annuity) shall be included in the gross income of the recipient if such amounts are received after the date on which the aggregate of all amounts excluded from gross income by the recipients under section 72(d) and prior income tax laws equalled or exceeded the consideration contributed (or deemed contributed) by the employee.

(2) If the rule of paragraph (a) of this section applies to amounts received by an employee (or his beneficiary or beneficiaries) under a joint and survivor annuity contract, payments made to a prior annuitant may entirely exhaust the amounts excludable from gross income. In such case, amounts paid to the surviving annuitant (or annuitants) shall be included in gross income by such recipients.

(d) *Application of section 72 (d) to a contract, trust, or plan providing for payments in a manner described in paragraph (b) (3) (i) of § 1.72–2.* For the purpose of applying section 72 (d) and this section, any amount received in the nature of a periodic payment under a contract, trust, or plan which provides for the payment of amounts in a manner described in paragraph (b) (3) (i) of § 1.72–2 shall be considered an amount received as an annuity notwithstanding the provisions of any other section of the regulations under section 72. The special exclusion rule of section 72 (d) and paragraph (a) of this section shall apply to all amounts so received if the first amount received, when multiplied by the number of periodic payments to be made within the three years beginning on the date of its receipt, results in an amount in excess of the aggregate premiums or other consideration contributed (or deemed contributed) by the employee as of that date. If more than one series of periodic payments is to be paid under the same contract, trust, or plan, all payments anticipatable, whether because fixed in amount or determinable in the manner described in the preceding sentence, shall be aggravated for the purpose of determining the applicability of section 72 (d) to the contract, trust, or plan as a whole.

(e) *Inapplicability of section 72 (d) and this section.* Section 72 (d) and this section do not apply to:

(1) Amounts received as proceeds of a life insurance contract to which section 101 (a) applies, nor to

(2) Amounts paid to a surviving annuitant under a joint and survivor annuity contract to which paragraph (b) (3) of § 1.72–5 applies.

See also paragraph (d) of § 1.72–14.

§ 1.72–14 Exceptions from application of principles of section 72.

(a) *Payments of interest.* If any amount is received under an agreement to pay interest on a sum or sums held by the obligor, such amount shall not be excludable from the gross income of the recipient under the provisions of section 72 to the extent that it is an actual interest payment. See section 72 (j). An amount shall be considered to be held under an agreement to pay interest thereon if the amount payable after the term of the annuity (whether for a term certain or for a life or lives) is substantially equal to or larger than the aggregate amount of premiums or other consideration paid therefor. For this purpose, however, the aggregate amount of premiums or other consideration paid shall include all contributions made by an employer and not merely those to which section 72 (f) applies.

(b) *Alimony payments.* To the extent that payments made to a wife are includible in her gross income by reason of either or both sections 71 and 682, they shall not be excluded from the wife's gross income under the principles of section 72 although made under a contract to which that section applies. However, section 72 shall apply in the case of amounts received under such a contract if a husband and wife are entitled to make and do make a single return jointly.

(c) *Certain "face-amount certificates."* The principles of section 72 do not apply to "face-amount certificates" described in section 72 (1) which were issued before January 1, 1955.

(d) *Employer plans.* The provisions of §§ 1.72–1 to 1.72–13, inclusive, shall be disregarded to the extent that they are inconsistent with the treatment of amounts received provided in section 402 (relating to the taxability of a beneficiary of an employees' trust), section 403 (relating to the taxation of employee annuities), or the regulations under either of such sections.

§ 1.72–15 Applicability of section 72 to accident or health plans.

(a) *Applicability of section.* This section provides the rules for determining the taxation of amounts received from an employer-established plan which provides for distributions that are taxable under section 72 (or, in the case of certain total distributions, under section 402(a)(2) or section 403(a)(2)) and which also provides for distributions that may be excludable from gross income under section 104 or 105 as accident or health benefits. For example, this section will apply to a pension plan described in section 401 and exempt under section 501 which provides for the payment of pensions at retirement and the payment of an earlier pension in the event of permanent disability. This section will also apply to a profit-sharing plan described in section 401 and exempt under section 501 which provides for periodic distribution of the amount standing to the account of a participant during any period that the participant is absent from work due to a personal injury or sickness and for the distribution of any balance standing to the account of the participant upon his separation from service. For purposes of this section, the term "contributions of the employee" includes contributions by the employer which were includible in the employee's gross income.

(b) *General rule.* Section 72 does not apply to any amount received as an accident or health benefit, and the tax treatment of any such amount shall be determined under sections 104 and 105. See paragraphs (c) and (d) of this section, paragraph (d) of § 1.104–1, and §§ 1.105–1 through 1.105–5. Section 72 (or, in the case of certain total distributions, section 402(a)(2) or section 403 (a)(2)) does apply to any amount which is received under a plan to which this section applies and which is not an accident or health benefit. See paragraph (e) of this section.

(c) *Accident or health benefits attributable to employee contributions.* (1) If a plan to which this section applies provides that any portion of the accident or health benefits is attributable to the contributions of the employee to such plan, then such portion of such benefits is excludable from gross income under section 104(a)(3) and paragraph (d) of § 1.104–1. Neither section 72 nor section 105 applies to any accident or health benefits (whether paid before or after retirement) attributable to contributions of the employee. Since such portion is excludable under section 104(a)(3), such portion is not subject to the $100-a-week limitation of section 105(d) and if such portion is payable after the retirement of the employee, it is excludable without regard to the provisions of § 1.105–4 and section 72.

(2) In determining the taxation of any amounts received as accident or health benefits from a plan to which this section applies, the first step is to determine the portion, if any, of the contributions of the employee which is used to provide the accident or health benefits and the portion of the accident or health benefits attributable to such portion of the employee's contributions. If such a plan expressly provides that the accident or health benefits are provided in whole or in part by employee contributions and the portion of employee contributions to be used for such purpose, the contributions so used will be treated as used to provide accident or health benefits. However, if the plan does not expressly provide that the accident or health benefits are to be provided with employee contributions and the portion of employee contributions to be used for such purpose, it will be presumed that none of the employee contributions is used to provide such benefits. Thus, in the case of a contributory pension plan, it will be presumed that the disability pension is provided by employer contributions, unless the plan expressly provides otherwise, or in the case of a contributory profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, it will be presumed that such insurance is purchased with employer contributions, unless the plan expressly provides otherwise. Similarly, unless the plan expressly provides otherwise, it will be presumed that if a contributory profit-sharing plan provides for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, all such distributions which do not exceed the contributions of the employer plus earnings thereon are provided by employer contributions.

(3) Any employee contributions that are treated under subparagraph (2) of this paragraph as used to provide accident or health benefits shall not be included for any purpose under section 72 as employee contributions or as aggregate premiums or other consideration paid. Thus, in the case of a pension plan, or in the case of a profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, any employee whose contributions are so used must make the adjustment provided by this subparagraph irrespective of whether such employee receives any accident or health benefits under such plan. However, in the case of a profit-sharing plan providing for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, an adjustment under this subparagraph is required only when an employee receives distributions in excess of the employer contributions and earnings thereon or receives distributions consisting in whole or in part of his own contributions.

(4) If any of the employee contributions are treated under subparagraph (2) of this paragraph as used to provide any of the accident or health benefits, the portion of the benefits attributable to employee contributions shall be determined in accordance with § 1.105–1. Any accident or health benefits that are excludable under section 104(a)(3) shall not be included in the expected return for purposes of section 72.

(d) *Accident or health benefits attributable to employer contributions.* Any amounts received as accident or health benefits and not attributable to contriutions of the employee are includible in gross income except to the extent that such amounts are excludable from gross income under section 105 (b), (c), or (d) and the regulations thereunder. Thus, such amounts may be excludable under section 105(d) as payments under a wage continuation plan. However, if such payments, when added to other such payments attributable to employer contributions, exceed the limitations of section 105(d), then the excess is includible in gross income under section 105(a). Such excess is not excludable under section 72.

(e) *Other benefits under the plan.* The taxability of amounts that are received under a plan to which this section applies and that are not accident or health benefits is determined under section 72 (or, in the case of certain total distributions, under section 402(a)(2) or section 403(a)(2)) without regard to any exclusion or inclusion of accident or health benefits under sections 104 and 105. For example, the investment in the contract or aggregate premiums paid is determined without regard to the exclusion of any amount under section 104 or 105, and the annuity starting date is determined without regard to the receipt of any accident or health benefits. However, if any employee contributions are used to provide any accident or health benefits, the investment in the contract or aggregate premiums paid must be adjusted as provided in paragraph (c)(3) of this section.

(f) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). A, an employee, is a participant in a contributory pension plan described in section 401(a) and exempt under section 501(a). Such plan provides for the payment of a pension to each participant when he retires at age 65 or when he retires earlier if the retirement is due to permanent and total disability. In 1958, A, who was age 52, became totally and permanently disabled because of an injury and commenced to receive a pension of $88 a week under this plan. A had contributed $11,804 to the plan. The plan does not expressly provide that any portion of the disability pension is purchased with employee contributions. Accordingly, it is presumed that no portion of the disability pension is purchased with A's contributions. The disability pension which A receives qualifies as payments under a wage continuation plan for purposes of section 105(d) and § 1.105–4, and if such payments are the only accident or health

after the date on which such lump sum first becomes payable, exercises an option or irrevocably agrees with the obligor to take, in lieu thereof, payments which will constitute "amounts received as an annuity", as that term is defined in paragraph (b) of § 1.72–2, no part of such lump sum shall be deemed to have been received by the obligee at the time he was first entitled thereto merely because he would have been entitled to such amount had he not exercised the option or made such an agreement with the obligor.

§ 1.72–13 Special rule for employee contributions recoverable in three years.

(a) *Amounts received as an annuity.* (1) Section 72(d) provides a special rule for the treatment of amounts received as an annuity by an employee (or by the beneficiary or beneficiaries of an employee) under a contract to which section 72 applies. This special rule is applicable only in the event that:

(i) At least part of the consideration paid for the contract is contributed by the employer, and

(ii) The aggregate amount receivable as an annuity under such contract by the employee (or by his beneficiary or beneficiaries if the employee died before any amount was received as an annuity under the contract) within the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received as an annuity equals or exceeds the total consideration contributed (or deemed contributed under section 72 (f) and § 1.72–8) by the employee as of such date as reduced by all amounts previously received and excludable from the gross income of the recipient under the applicable income tax law.

In such an event, section 72 (d) provides that all amounts received as an annuity under the contract during a taxable year to which the Code applies shall be excluded from gross income until the total of the amounts excluded under that section plus all amounts excluded under prior income tax laws equals or exceeds the consideration contributed (or deemed contributed) by the employee. The excess, if any, and all amounts received by any recipient thereafter (whether or not received as an annuity), shall be fully included in gross income. See paragraph (b) of this section.

(2) If the aggregate amount receivable as an annuity under the contract within three years from the date on which an amount is first received as an annuity thereunder will not equal or exceed the consideration contributed (or deemed contributed) by the employee in accordance with the provisions of § 1.72–8, computed as of such date, the special rule of section 72 (d) shall not apply to amounts received as an annuity under the contract and the general rules of section 72 shall apply thereto.

(3) The aggregate of the amounts receivable as an annuity within the prescribed 3-year period shall be the total of all annuity payments anticipatable by an employee (or a beneficiary or beneficiaries of an employee, if the employee died before any amount was received as whole as defined in paragraph (a) of § 1.72–2. However, as provided in paragraph (a) of § 1.72–2, the applicability of section 72 (d) and this section shall be determined separately with respect to each separate plan or trust in which the employee has an interest. For example, the applicability of this section and section 72 (d) to amounts received under a Civil Service Retirement annuity which is paid as the result of involuntary contributions of an employee shall be considered separately from the applicability of such sections to amounts received under such an annuity which is paid as the result of voluntary contributions of the employee.

(4) If subparagraphs (1) and (3) of this paragraph apply to amounts received as an annuity under a contract, the rule prescribed in subparagraph (1) of this paragraph shall apply to all amounts so received thereunder regardless of the fact that they may be payable (i) to more than one beneficiary, (ii) for the same or different intervals, (iii) in different sums, or (iv) for a different period certain, life, or lives.

(b) *Amounts not received as an annuity.* If the rule of paragraph (a) of this section applies to a contract and, after the date on which an annuity payment is first received, amounts are received other than as an annuity under such contract in a taxable year to which the Code applies, they shall be included in the gross income of the recipient in accordance with the provisions of § 1.72–11. Thus, if such amounts are received as a dividend or a similar distribution after the date on which an amount is first received as an annuity under the contract, they shall be included in the gross income of the recipient (in accordance with section 72 (e) (1) (A) and paragraph (b) (2) of § 1.72–11. All other amounts not received as an annuity shall be included in the gross income of the recipient in accordance with the provisions of section 72 (e) (1) (B) and paragraph (c), (d), or (f), whichever is applicable, of § 1.72–11. See section 72 (e) (2).

(c) *Amounts received after the exhaustion of employee contributions.* (1) Amounts received under a contract to which the rule of paragraph (a) of this section applies (whether or not such amounts are received as an annuity) shall be included in the gross income of the recipient if such amounts are received after the date on which the aggregate of all amounts excluded from gross income by the recipients under section 72(d) and prior income tax laws equalled or exceeded the consideration contributed (or deemed contributed) by the employee.

(2) If the rule of paragraph (a) of this section applies to amounts received by an employee (or his beneficiary or beneficiaries) under a joint and survivor annuity contract, payments made to a prior annuitant may entirely exhaust the amounts excludable from gross income. In such case, amounts paid to the surviving annuitant (or annuitants) shall be included in gross income by such recipients.

(d) *Application of section 72 (d) to a contract, trust, or plan providing for payments in a manner described in paragraph (b) (3) (i) of § 1.72–2.* For the purpose of applying section 72 (d) and this section, any amount received in the nature of a periodic payment under a contract, trust, or plan which provides for the payment of amounts in a manner described in paragraph (b) (3) (i) of § 1.72–2 shall be considered an amount received as an annuity notwithstanding the provisions of any other section of the regulations under section 72. The special exclusion rule of section 72 (d) and paragraph (a) of this section shall apply to all amounts so received if the first amount received, when multiplied by the number of periodic payments to be made within the three years beginning on the date of its receipt, results in an amount in excess of the aggregate premiums or other consideration contributed (or deemed contributed) by the employee as of that date. If more than one series of periodic payments is to be paid under the same contract, trust, or plan, all payments anticipatable, whether because fixed in amount or determinable in the manner described in the preceding sentence, shall be aggravated for the purpose of determining the applicability of section 72 (d) to the contract, trust, or plan as a whole.

(e) *Inapplicability of section 72 (d) and this section.* Section 72 (d) and this section do not apply to:

(1) Amounts received as proceeds of a life insurance contract to which section 101 (a) applies, nor to

(2) Amounts paid to a surviving annuitant under a joint and survivor annuity contract to which paragraph (b) (3) of § 1.72–5 applies.

See also paragraph (d) of § 1.72–14.

§ 1.72–14 Exceptions from application of principles of section 72.

(a) *Payments of interest.* If any amount is received under an agreement to pay interest on a sum or sums held by the obligor, such amount shall not be excludable from the gross income of the recipient under the provisions of section 72 to the extent that it is an actual interest payment. See section 72 (j). An amount shall be considered to be held under an agreement to pay interest thereon if the amount payable after the term of the annuity (whether for a term certain or for a life or lives) is substantially equal to or larger than the aggregate amount of premiums or other consideration paid therefor. For this purpose, however, the aggregate amount of premiums or other consideration paid shall include all contributions made by an employer and not merely those to which section 72 (f) applies.

(b) *Alimony payments.* To the extent that payments made to a wife are includible in her gross income by reason of either or both sections 71 and 682, they shall not be excluded from the wife's gross income under the principles of section 72 although made under a contract to which that section applies. However, section 72 shall apply in the case of amounts received under such a contract if a husband and wife are entitled to make and do make a single return jointly.

(c) *Certain "face-amount certificates."* The principles of section 72 do not apply to "face-amount certificates" described in section 72 (1) which were issued before January 1, 1955.

(d) *Employer plans.* The provisions of §§ 1.72–1 to 1.72–13, inclusive, shall be disregarded to the extent that they are inconsistent with the treatment of amounts received provided in section 402 (relating to the taxability of a beneficiary of an employees' trust), section 403 (relating to the taxation of employee annuities), or the regulations under either of such sections.

§ 1.72–15 Applicability of section 72 to accident or health plans.

(a) *Applicability of section.* This section provides the rules for determining the taxation of amounts received from an employer-established plan which provides for distributions that are taxable under section 72 (or, in the case of certain total distributions, under section 402(a)(2) or section 403(a)(2)) and which also provides for distributions that may be excludable from gross income under section 104 or 105 as accident or health benefits. For example, this section will apply to a pension plan described in section 401 and exempt under section 501 which provides for the payment of pensions at retirement and the payment of an earlier pension in the event of permanent disability. This section will also apply to a profit-sharing plan described in section 401 and exempt under section 501 which provides for periodic distribution of the amount standing to the account of a participant during any period that the participant is absent from work due to a personal injury or sickness and for the distribution of any balance standing to the account of the participant upon his separation from service. For purposes of this section, the term "contributions of the employee" includes contributions by the employer which were includible in the employee's gross income.

(b) *General rule.* Section 72 does not apply to any amount received as an accident or health benefit, and the tax treatment of any such amount shall be determined under sections 104 and 105. See paragraphs (c) and (d) of this section, paragraph (d) of § 1.104–1, and §§ 1.105–1 through 1.105–5. Section 72 (or, in the case of certain total distributions, section 402(a)(2) or section 403(a)(2)) does apply to any amount which is received under a plan to which this section applies and which is not an accident or health benefit. See paragraph (e) of this section.

(c) *Accident or health benefits attributable to employee contributions.* (1) If a plan to which this section applies provides that any portion of the accident or health benefits is attributable to the contributions of the employee to such plan, then such portion of such benefits is excludable from gross income under section 104(a)(3) and paragraph (d) of § 1.104–1. Neither section 72 nor section 105 applies to any accident or health benefits (whether paid before or after retirement) attributable to contributions of the employee. Since such portion is excludable under section 104(a)(3), such portion is not subject to the $100-a-week limitation of section 105(d) and if such portion is payable after the retirement of the employee, it is excludable without regard to the provisions of § 1.105–4 and section 72.

(2) In determining the taxation of any amounts received as accident or health benefits from a plan to which this section applies, the first step is to determine the portion, if any, of the contributions of the employee which is used to provide the accident or health benefits and the portion of the accident or health benefits attributable to such portion of the employee's contributions. If such a plan expressly provides that the accident or health benefits are provided in whole or in part by employee contributions and the portion of employee contributions to be used for such purpose, the contributions so used will be treated as used to provide accident or health benefits. However, if the plan does not expressly provide that the accident or health benefits are to be provided with employee contributions and the portion of employee contributions to be used for such purpose, it will be presumed that none of the employee contributions is used to provide such benefits. Thus, in the case of a contributory pension plan, it will be presumed that the disability pension is provided by employer contributions, unless the plan expressly provides otherwise, or in the case of a contributory profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, it will be presumed that such insurance is purchased with employer contributions, unless the plan expressly provides otherwise. Similarly, unless the plan expressly provides otherwise, it will be presumed that if a contributory profit-sharing plan provides for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, all such distributions which do not exceed the contributions of the employer plus earnings thereon are provided by employer contributions.

(3) Any employee contributions that are treated under subparagraph (2) of this paragraph as used to provide accident or health benefits shall not be included for any purpose under section 72 as employee contributions or as aggregate premiums or other consideration paid. Thus, in the case of a pension plan, or in the case of a profit-sharing plan providing that a portion of the amount standing to the account of each participant will be used to purchase accident or health insurance, any employee whose contributions are so used must make the adjustment provided by this subparagraph irrespective of whether such employee receives any accident or health benefits under such plan. However, in the case of a profit-sharing plan providing for periodic distributions from the account of a participant during any absence from work because of a personal injury or sickness, an adjustment under this subparagraph is required only when an employee receives distributions in excess of the employer contributions and earnings thereon or receives distributions consisting in whole or in part of his own contributions.

(4) If any of the employee contributions are treated under subparagraph (2) of this paragraph as used to provide any of the accident or health benefits, the portion of the benefits attributable to employee contributions shall be determined in accordance with § 1.105–1. Any accident or health benefits that are excludable under section 104(a)(3) shall not be included in the expected return for purposes of section 72.

(d) *Accident or health benefits attributable to employer contributions.* Any amounts received as accident or health benefits and not attributable to contriutions of the employee are includible in gross income except to the extent that such amounts are excludable from gross income under section 105 (b), (c), or (d) and the regulations thereunder. Thus, such amounts may be excludable under section 105(d) as payments under a wage continuation plan. However, if such payments, when added to other such payments attributable to employer contributions, exceed the limitations of section 105(d), then the excess is includible in gross income under section 105(a). Such excess is not excludable under section 72.

(e) *Other benefits under the plan.* The taxability of amounts that are received under a plan to which this section applies and that are not accident or health benefits is determined under section 72 (or, in the case of certain total distributions, under section 402(a)(2) or section 403(a)(2)) without regard to any exclusion or inclusion of accident or health benefits under sections 104 and 105. For example, the investment in the contract or aggregate premiums paid is determined without regard to the exclusion of any amount under section 104 or 105, and the annuity starting date is determined without regard to the receipt of any accident or health benefits. However, if any employee contributions are used to provide any accident or health benefits, the investment in the contract or aggregate premiums paid must be adjusted as provided in paragraph (c)(3) of this section.

(f) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). A, an employee, is a participant in a contributory pension plan described in section 401(a) and exempt under section 501(a). Such plan provides for the payment of a pension to each participant when he retires at age 65 or when he retires earlier if the retirement is due to permanent and total disability. In 1958, A, who was age 52, became totally and permanently disabled because of an injury and commenced to receive a pension of $88 a week under this plan. A had contributed $11,804 to the plan. The plan does not expressly provide that any portion of the disability pension is purchased with employee contributions. Accordingly, it is presumed that no portion of the disability pension is purchased with A's contributions. The disability pension which A receives qualifies as payments under a wage continuation plan for purposes of section 105(d) and § 1.105–4, and if such payments are the only accident or health

benefits which are attributable to the contributions of his employer, such payments are entirely excludable under section 105(d) until A reaches age 65, his normal retirement age under the plan. The payments which A receives after he becomes age 65 are taxable under section 72. The payments which A receives do constitute an annuity as defined in paragraph (b) of § 1.72–2, but since the amounts which he will receive during the first three years after attaining age 65 exceed his contributions, he shall exclude under § 1.72–13 the entire amount of all payments that he receives as an annuity after attaining age 65 until such amounts equal his contributions to the plan, or $11,804. Thereafter, the payments that he receives under the plan are includible in gross income.

Example (2). B, an employee, is a participant in a contributory profit-sharing plan described in section 401(a) and exempt under section 501(a). Such plan provides that, in the event a participant is absent from work because of a personal injury or sickness, he will be paid $125 a week out of his account in such plan. Any amount standing to the account of a participant at the time of his separation from service will be paid to him at such time. During 1958, B incurred a personal injury and as a result was absent from work for nine weeks. He received nine weekly payments of $125, or a total of $1,125, on account of such absence from work. At the time B was injured, he had contributed $5,000 to the plan. The plan did not expressly provide that a participant's contributions are to be used to provide for the distributions during disability. Accordingly, it is presumed that B's contributions were not used to provide the accident or health benefits under the plan. Since these weekly payments are paid because of B's absence from work due to the injury, and since such payments are considered as attributable to contributions of his employer, such payments are required under section 105(a) to be included in B's gross income except to the extent that they are excludable under section 105(d). If B receives no other payments under a wage continuation plan attributable to contributions of his employer, $100 of each weekly payment is excludable from gross income under section 105(d), but $25 of each weekly payment is includible in gross income under section 105(a). The $100-a-week payment so excludable does not reduce B's investment in the contract or the amount of premiums considered to have been paid by B for purposes of any subsequent computations under section 72.

Example (3). The facts are the same as in example (2) except that B was absent from work for 130 weeks. At the time B was injured, his employer had contributed $10,000 to the plan on his account, and $6,000 of earnings of the plan had been allocated to his account. Thus, at the time he was injured, B's account included $21,000, and $14,000 of such amount consists of employer contributions of $10,000 plus earnings of $4,000 thereon. The first 112 weekly payments (totaling $14,000) which B receives are treated in the manner set forth in example (2). However, since the remaining payments exceed the employer contributions plus earnings thereon, such remaining payments are considered to be distributions of B's contributions plus earnings thereon. Since the total of such payments, or $2,250, is less than B's contributions to the plan, $5,000, the entire amount of such payments is excludable from B's gross income, but a corresponding adjustment with respect to the return of B's contributions shall be made to his consideration in determining the taxation of any lump sum paid to B upon separation from service.

§ 1.73 Statutory provisions; services of child.

SEC. 73. *Services of child*—(a) *Treatment of amounts received.* Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child.

(b) *Treatment of expenditures.* All expenditures by the parent or the child attributable to amounts which are includible in the gross income of the child (and not of the parent) solely by reason of subsection (a) shall be treated as paid or incurred by the child.

(c) *Parent defined.* For purposes of this section, the term "parent" includes an individual who is entitled to the services of a child by reason of having parental rights and duties in respect of the child.

(d) *Cross reference.* For assessment of tax against parent in certain cases, see section 6201 (c).

§ 1.73–1 Services of child.

(a) Compensation for personal services of a child shall, regardless of the provisions of State law relating to who is entitled to the earnings of the child, and regardless of whether the income is in fact received by the child, be deemed to be the gross income of the child and not the gross income of the parent of the child. Such compensation, therefore, shall be included in the gross income of the child and shall be reflected in the return rendered by or for such child. The income of a minor child is not required to be included in the gross income of the parent for income tax purposes. For requirements for making the return by such child, or for such child by his guardian, or other person charged with the care of his person or property, see section 6012.

(b) In the determination of taxable income or adjusted gross income, as the case may be, all expenditures made by the parent or the child attributable to amounts which are includible in the gross income of the child and not of the parent solely by reason of section 73 are deemed to have been paid or incurred by the child. In such determination, the child is entitled to take deductions not only for expenditures made on his behalf by his parent which would be commonly considered as business expenses, but also for other expenditures such as charitable contributions made by the parent in the name of the child and out of the child's earnings.

(c) For purposes of section 73, the term "parent" includes any individual who is entitled to the services of the child by reason of having parental rights and duties in respect of the child. See section 6201 (c) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) for assessment of tax against the parent in certain cases.

§ 1.74 Statutory provisions; prizes and awards.

SEC. 74. *Prizes and awards*—(a) *General rule.* Except as provided in subsection (b) and in section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.

(b) *Exception.* Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—

(1) The recipient was selected without any action on his part to enter the contest or proceeding; and

(2) The recipient is not required to render substantial future services as a condition to receiving the prize or award.

§ 1.74–1 Prizes and awards.

(a) *Inclusion in gross income.* (1) Section 74(a) requires the inclusion in gross income of all amounts received as prizes and awards, unless such prizes or awards qualify as an exclusion from gross income under subsection (b), or unless such prize or award is a scholarship or fellowship grant excluded from gross income by section 117. Prizes and awards which are includible in gross income include (but are not limited to) amounts received from radio and television give-away shows, door prizes, and awards in contests of all types, as well as any prizes and awards from an employer to an employee in recognition of some achievement in connection with his employment.

(2) If the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income.

(b) *Exclusion from gross income.* Section 74 (b) provides an exclusion from gross income of any amount received as a prize or award, if (1) such prize or award was made primarily in recognition of past achievements of the recipient in religious, charitable, scientific, educational, artistic, literary, or civic fields; (2) the recipient was selected without any action on his part to enter the contest or proceedings; and (3) the recipient is not required to render substantial future services as a condition to receiving the prize or award. Thus, such awards as the Nobel prize and the Pulitzer prize would qualify for the exclusion. Section 74 (b) does not exclude prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment.

(c) *Scholarships and fellowship grants.* See section 117 and the regulations thereunder for provisions relating to scholarships and fellowship grants.

§ 1.75 Statutory provisions; dealers in tax-exempt securities.

SEC. 75. *Dealers in tax-exempt securities*—(a) *Adjustment for bond premium.* In computing the gross income of a taxpayer who holds during the taxable year a short-term municipal bond (as defined in subsection (b) (1)) primarily for sale to customers in the ordinary course of his trade or business—

(1) if the gross income of the taxpayer from such trade or business is computed by the use of inventories and his inventories are valued on any basis other than cost, the cost of securities sold (as defined in subsection (b) (2)) during such year shall be reduced by an amount equal to the amortizable bond premium which would be disallowed as a deduction for such year by section 171 (a) (2) (relating to deduction for amortizable bond premium) if the definition in section 171 (d) of the term "bond" did not exclude such short-term municipal bond; or

(2) if the gross income of the taxpayer from such trade or business is computed without the use of inventories, or by use of inventories valued at cost, and the short-term municipal bond is sold or otherwise disposed of during such year, the adjusted basis (computed without regard to this paragraph) of the short-term municipal bond shall be reduced by the amount of the adjustment which would be required under section 1016 (a) (5) (relating to adjustment to basis for amortizable bond premium) if the definition in section 171 (d) of the term "bond" did not exclude such short-term municipal bond.

(b) *Definitions.* For purposes of subsection (a)—

(1) The term "short-term municipal bond" means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludable from gross income; but such term does not include such an obligation if—

(A) It is sold or otherwise disposed of by the taxpayer within 30 days after the date of its acquisition by him, or

(B) Its earliest maturity or call date is a date more than 5 years from the date on which it was acquired by the taxpayer.

(2) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum—

(A) The inventory value of the opening inventory for such year, and

(B) The cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

§ 1.75–1 Treatment of bond premiums in case of dealers in tax-exempt securities.

(a) *In general.* (1) Section 75 requires certain adjustments to be made by dealers in securities with respect to premiums paid on short-term municipal bonds which are held for sale to customers in the ordinary course of the trade or business. The adjustments depend upon the method of accounting used by the taxpayer in computing the gross income from the trade or business. See paragraphs (b) and (c) of this section.

(2) The term "short-term municipal bond" under section 75 means any obligation issued by a government or political subdivision thereof if the interest on the obligation is excludable from gross income under section 103. Such term, however, does not include an obligation the maturity or earliest call date of which is a date more than five years from the date of acquisition by the taxpayer, or an obligation sold or otherwise disposed of by the taxpayer within 30 days after the date of acquisition by him. A bond which is otherwise within the definition of "short-term municipal bond" is subject to the provisions of section 75 if held by the taxpayer for a period of more than 30 days, whether or not such period is entirely within one taxable year.

(3) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of the inventory value of the opening inventory for such year and the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) *Inventories not valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business by the use of inventories and values such inventories on any basis other than cost, the adjustment required by section 75 is the reduction of "cost of securities sold" by the amount equal to the amortizable bond premium which would be disallowed as a deduction under section 171 (a) (2) with respect to the short-term municipal bond if the dealer were an ordinary investor holding such bond. Such amortizable bond premium is computed under section 171 (b) by reference to the cost or other original basis of the bond on the date of acquisition (determined without regard to section 1013, relating to inventory value on a subsequent date).

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X, a dealer in securities who values his inventories on a basis other than cost, makes his income tax returns on the calendar year basis. On July 1, 1954, he bought, for $1,060 each, three short-term municipal bonds (A, B, and C) having a face obligation of $1,000, and maturing on July 1, 1959. Bond A is sold on December 31, 1954, bond B is sold on December 31, 1955, and bond C is sold on June 30, 1956. For each bond the amortizable bond premium to maturity is $60, the period from date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1. The adjustment for each of the years 1954, 1955, and 1956 is as follows:

Bond	Date acquired	Date sold	Adjustment to "cost of securities sold" for—		
			1954	1955	1956
A	July 1, 1954	Dec. 31, 1954	$6	-----	-----
B	July 1, 1954	Dec. 31, 1955	6	$12	-----
C	July 1, 1954	June 30, 1956	6	12	$6
		Total	18	24	6

(c) *Inventories not used or inventories valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business without the use of inventories or by use of inventories valued at cost, the adjustment required by section 75 is a reduction of the adjusted basis of each short-term municipal bond sold or otherwise disposed of during the taxable year. The amount of such reduction is the amount by which the adjusted basis of such bond would be required to be reduced under section 1016 (a) (5) were such bond subject to the amortizable bond premium provisions of section 171, that is, the amount of the amortizable bond premium which would be disallowed as a deduction under section 171 (a) (2) if the taxpayer were an ordinary investor.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Y, a dealer in securities who values his inventories on the basis of cost, makes his income tax returns on the calendar year basis. On January 1, 1954, he buys, for $1,060 each, three short-term municipal bonds (D, E, and F) having a face obligation of $1,000, and maturing on January 1, 1959. Bond D is sold on December 31, 1954, bond E is sold on June 30, 1955, and bond F is sold on December 31, 1956. For each bond, the amortizable bond premium to maturity is $60, the period from the date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1.

Bond	Date acquired	Date sold	Adjustment for—		
			1954	1955	1956
D	Jan. 1, 1954	Dec. 31, 1954	$12	-----	-----
E	Jan. 1, 1954	June 30, 1955	None	$18	-----
F	Jan. 1, 1954	Dec. 31, 1956	None	None	$36

(d) *Bonds acquired before July 1, 1950.* Under section 203 (c) of the Revenue Act of 1950 (64 Stat. 906), adjustment is required for a short-term municipal bond acquired before July 1, 1950, only with respect to taxable years beginning on or after that date. Accordingly, if the short-term municipal bond was acquired before July 1, 1950, then for purposes of section 75 the amortizable bond premium under section 171 must be computed after adjusting the bond premium to the extent proper to reflect unamortized bond premium for so much of the holding period (as determined under section 1223) as precedes the first taxable year of the dealer beginning on or after July 1, 1950. Thus, in the examples in paragraphs (b) and (c) of this section, the first taxable year beginning on or after July 1, 1950, is, for each dealer, the taxable year beginning January 1, 1951. If each dealer had purchased for $1,060 on April 1, 1950, a short-term municipal bond having a face obligation of $1,000 and maturing April 1, 1955, and had sold such bond on February 28, 1955, the adjustment under section 75 would be computed as follows:

	Dealer X	Dealer Y
Bond premium	$60	$60
Adjustment for holding period prior to Jan. 1, 1951	9	9
Amortizable bond premium to maturity, as adjusted	51	51
Amortizable bond premium per month	1	1
Total adjustments under section 22 (o), 1939 Code, for years 1951–53	36	None
Adjustment under section 75 for 1954	12	None
Adjustment under section 75 for 1955	2	50

§ 1.76 Statutory provisions; mortgages made or obligations issued by joint-stock land banks.

SEC. 76. *Mortgages made or obligations issued by joint-stock land banks.* All income (except interest) derived from mortgages made, or obligations issued, after May 28, 1938, by a joint-stock land bank shall (notwithstanding section 26 of the Federal Farm Loan Act; 12 U. S. C. 931–3) be included in gross income.

§ 1.77 Statutory provisions; commodity credit loans.

SEC. 77. *Commodity credit loans*—(a) *Election to include loans in income.*

benefits which are attributable to the contributions of his employer, such payments are entirely excludable under section 105(d) until A reaches age 65, his normal retirement age under the plan. The payments which A receives after he becomes age 65 are taxable under section 72. The payments which A receives do constitute an annuity as defined in paragraph (b) of § 1.72–2, but since the amounts which he will receive during the first three years after attaining age 65 exceed his contributions, he shall exclude under § 1.72–13 the entire amount of all payments that he receives as an annuity after attaining age 65 until such amounts equal his contributions to the plan, or $11,804. Thereafter, the payments that he receives under the plan are includible in gross income.

Example (2). B, an employee, is a participant in a contributory profit-sharing plan described in section 401(a) and exempt under section 501(a). Such plan provides that, in the event a participant is absent from work because of a personal injury or sickness, he will be paid $125 a week out of his account in such plan. Any amount standing to the account of a participant at the time of his separation from service will be paid to him at such time. During 1958, B incurred a personal injury and as a result was absent from work for nine weeks. He received nine weekly payments of $125, or a total of $1,125, on account of such absence from work. At the time B was injured, he had contributed $5,000 to the plan. The plan did not expressly provide that a participant's contributions are to be used to provide for the distributions during disability. Accordingly, it is presumed that B's contributions were not used to provide the accident or health benefits under the plan. Since these weekly payments are paid because of B's absence from work due to the injury, and since such payments are considered as attributable to contributions of his employer, such payments are required under section 105(a) to be included in B's gross income except to the extent that they are excludable under section 105(d). If B receives no other payments under a wage continuation plan attributable to contributions of his employer, $100 of each weekly payment is excludable from gross income under section 105(d), but $25 of each weekly payment is includible in gross income under section 105(a). The $100-a-week payment so excludable does not reduce B's investment in the contract or the amount of premiums considered to have been paid by B for purposes of any subsequent computations under section 72.

Example (3). The facts are the same as in example (2) except that B was absent from work for 130 weeks. At the time B was injured, his employer had contributed $10,000 to the plan on his account, and $6,000 of earnings of the plan had been allocated to his account. Thus, at the time he was injured, B's account included $21,000, and $14,000 of such amount consists of employer contributions of $10,000 plus earnings of $4,000 thereon. The first 112 weekly payments (totaling $14,000) which B receives are treated in the manner set forth in example (2). However, since the remaining payments exceed the employer contributions plus earnings thereon, such remaining payments are considered to be distributions of B's contributions plus earnings thereon. Since the total of such payments, or $2,250, is less than B's contributions to the plan, $5,000, the entire amount of such payments is excludable from B's gross income, but a corresponding adjustment with respect to the return of B's contributions shall be made to his consideration in determining the taxation of any lump sum paid to B upon separation from service.

§ 1.73 Statutory provisions; services of child.

SEC. 73. *Services of child*—(a) *Treatment of amounts received.* Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child.

(b) *Treatment of expenditures.* All expenditures by the parent or the child attributable to amounts which are includible in the gross income of the child (and not of the parent) solely by reason of subsection (a) shall be treated as paid or incurred by the child.

(c) *Parent defined.* For purposes of this section, the term "parent" includes an individual who is entitled to the services of a child by reason of having parental rights and duties in respect of the child.

(d) *Cross reference.* For assessment of tax against parent in certain cases, see section 6201 (c).

§ 1.73–1 Services of child.

(a) Compensation for personal services of a child shall, regardless of the provisions of State law relating to who is entitled to the earnings of the child, and regardless of whether the income is in fact received by the child, be deemed to be the gross income of the child and not the gross income of the parent of the child. Such compensation, therefore, shall be included in the gross income of the child and shall be reflected in the return rendered by or for such child. The income of a minor child is not required to be included in the gross income of the parent for income tax purposes. For requirements for making the return by such child, or for such child by his guardian, or other person charged with the care of his person or property, see section 6012.

(b) In the determination of taxable income or adjusted gross income, as the case may be, all expenditures made by the parent or the child attributable to amounts which are includible in the gross income of the child and not of the parent solely by reason of section 73 are deemed to have been paid or incurred by the child. In such determination, the child is entitled to take deductions not only for expenditures made on his behalf by his parent which would be commonly considered as business expenses, but also for other expenditures such as charitable contributions made by the parent in the name of the child and out of the child's earnings.

(c) For purposes of section 73, the term "parent" includes any individual who is entitled to the services of the child by reason of having parental rights and duties in respect of the child. See section 6201 (c) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) for assessment of tax against the parent in certain cases.

§ 1.74 Statutory provisions; prizes and awards.

SEC. 74. *Prizes and awards*—(a) *General rule.* Except as provided in subsection (b) and in section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.

(b) *Exception.* Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—

(1) The recipient was selected without any action on his part to enter the contest or proceeding; and

(2) The recipient is not required to render substantial future services as a condition to receiving the prize or award.

§ 1.74–1 Prizes and awards.

(a) *Inclusion in gross income.* (1) Section 74(a) requires the inclusion in gross income of all amounts received as prizes and awards, unless such prizes or awards qualify as an exclusion from gross income under subsection (b), or unless such prize or award is a scholarship or fellowship grant excluded from gross income by section 117. Prizes and awards which are includible in gross income include (but are not limited to) amounts received from radio and television give-away shows, door prizes, and awards in contests of all types, as well as any prizes and awards from an employer to an employee in recognition of some achievement in connection with his employment.

(2) If the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income.

(b) *Exclusion from gross income.* Section 74 (b) provides an exclusion from gross income of any amount received as a prize or award, if (1) such prize or award was made primarily in recognition of past achievements of the recipient in religious, charitable, scientific, educational, artistic, literary, or civic fields; (2) the recipient was selected without any action on his part to enter the contest or proceedings; and (3) the recipient is not required to render substantial future services as a condition to receiving the prize or award. Thus, such awards as the Nobel prize and the Pulitzer prize would qualify for the exclusion. Section 74 (b) does not exclude prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment.

(c) *Scholarships and fellowship grants.* See section 117 and the regulations thereunder for provisions relating to scholarships and fellowship grants.

§ 1.75 Statutory provisions; dealers in tax-exempt securities.

SEC. 75. *Dealers in tax-exempt securities*—(a) *Adjustment for bond premium.* In computing the gross income of a taxpayer who holds during the taxable year a short-term municipal bond (as defined in subsection (b) (1)) primarily for sale to customers in the ordinary course of his trade or business—

(1) if the gross income of the taxpayer from such trade or business is computed by the use of inventories and his inventories are valued on any basis other than cost, the cost of securities sold (as defined in subsection (b) (2)) during such year shall be reduced by an amount equal to the amortizable bond premium which would be disallowed as a deduction for such year by section 171 (a) (2) (relating to deduction for amortizable bond premium) if the definition in section 171 (d) of the term "bond" did not exclude such short-term municipal bond; or

(2) if the gross income of the taxpayer from such trade or business is computed without the use of inventories, or by use of inventories valued at cost, and the short-term municipal bond is sold or otherwise disposed of during such year, the adjusted basis (computed without regard to this paragraph) of the short-term municipal bond shall be reduced by the amount of the adjustment which would be required under section 1016 (a) (5) (relating to adjustment to basis for amortizable bond premium) if the definition in section 171 (d) of the term "bond" did not exclude such short-term municipal bond.

(b) *Definitions.* For purposes of subsection (a)—

(1) The term "short-term municipal bond" means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludable from gross income; but such term does not include such an obligation if—

(A) It is sold or otherwise disposed of by the taxpayer within 30 days after the date of its acquisition by him, or

(B) Its earliest maturity or call date is a date more than 5 years from the date on which it was acquired by the taxpayer.

(2) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum—

(A) The inventory value of the opening inventory for such year, and

(B) The cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

§ 1.75–1 Treatment of bond premiums in case of dealers in tax-exempt securities.

(a) *In general.* (1) Section 75 requires certain adjustments to be made by dealers in securities with respect to premiums paid on short-term municipal bonds which are held for sale to customers in the ordinary course of the trade or business. The adjustments depend upon the method of accounting used by the taxpayer in computing the gross income from the trade or business. See paragraphs (b) and (c) of this section.

(2) The term "short-term municipal bond" under section 75 means any obligation issued by a government or political subdivision thereof if the interest on the obligation is excludable from gross income under section 103. Such term, however, does not include an obligation the maturity or earliest call date of which is a date more than five years from the date of acquisition by the taxpayer, or an obligation sold or otherwise disposed of by the taxpayer within 30 days after the date of acquisition by him. A bond which is otherwise within the definition of "short-term municipal bond" is subject to the provisions of section 75 if held by the taxpayer for a period of more than 30 days, whether or not such period is entirely within one taxable year.

(3) The term "cost of securities sold" means the amount ascertained by subtracting the inventory value of the closing inventory of a taxable year from the sum of the inventory value of the opening inventory for such year and the cost of securities and other property purchased during such year which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) *Inventories not valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business by the use of inventories and values such inventories on any basis other than cost, the adjustment required by section 75 is the reduction of "cost of securities sold" by the amount equal to the amortizable bond premium which would be disallowed as a deduction under section 171 (a) (2) with respect to the short-term municipal bond if the dealer were an ordinary investor holding such bond. Such amortizable bond premium is computed under section 171 (b) by reference to the cost or other original basis of the bond on the date of acquisition (determined without regard to section 1013, relating to inventory value on a subsequent date).

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X, a dealer in securities who values his inventories on a basis other than cost, makes his income tax returns on the calendar year basis. On July 1, 1954, he bought, for $1,060 each, three short-term municipal bonds (A, B, and C) having a face obligation of $1,000, and maturing on July 1, 1959. Bond A is sold on December 31, 1954, bond B is sold on December 31, 1955, and bond C is sold on June 30, 1956. For each bond the amortizable bond premium to maturity is $60, the period from date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1. The adjustment for each of the years 1954, 1955, and 1956 is as follows:

Bond	Date acquired	Date sold	Adjustment to "cost of securities sold" for—		
			1954	1955	1956
A	July 1, 1954	Dec. 31, 1954	$6	----	----
B	July 1, 1954	Dec. 31, 1955	6	$12	----
C	July 1, 1954	June 30, 1956	6	12	$6
		Total..	18	24	6

(c) *Inventories not used or inventories valued at cost.* (1) In the case of a dealer in securities who computes gross income from his trade or business without the use of inventories or by use of inventories valued at cost, the adjustment required by section 75 is a reduction of the adjusted basis of each short-term municipal bond sold or otherwise disposed of during the taxable year. The amount of such reduction is the amount by which the adjusted basis of such bond would be required to be reduced under section 1016 (a) (5) were such bond subject to the amortizable bond premium provisions of section 171, that is, the amount of the amortizable bond premium which would be disallowed as a deduction under section 171 (a) (2) if the taxpayer were an ordinary investor.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Y, a dealer in securities who values his inventories on the basis of cost, makes his income tax returns on the calendar year basis. On January 1, 1954, he buys, for $1,060 each, three short-term municipal bonds (D, E, and F) having a face obligation of $1,000, and maturing on January 1, 1959. Bond D is sold on December 31, 1954, bond E is sold on June 30, 1955, and bond F is sold on December 31, 1956. For each bond, the amortizable bond premium to maturity is $60, the period from the date of acquisition to maturity is 60 months, and the amortizable bond premium per month is $1.

Bond	Date acquired	Date sold	Adjustment for—		
			1954	1955	1956
D	Jan. 1, 1954	Dec. 31, 1954	$12	----	----
E	Jan. 1, 1954	June 30, 1955	None	$18	----
F	Jan. 1, 1954	Dec. 31, 1956	None	None	$36

(d) *Bonds acquired before July 1, 1950.* Under section 203 (c) of the Revenue Act of 1950 (64 Stat. 906), adjustment is required for a short-term municipal bond acquired before July 1, 1950, only with respect to taxable years beginning on or after that date. Accordingly, if the short-term municipal bond was acquired before July 1, 1950, then for purposes of section 75 the amortizable bond premium under section 171 must be computed after adjusting the bond premium to the extent proper to reflect unamortized bond premium for so much of the holding period (as determined under section 1223) as precedes the first taxable year of the dealer beginning on or after July 1, 1950. Thus, in the examples in paragraphs (b) and (c) of this section, the first taxable year beginning on or after July 1, 1950, is, for each dealer, the taxable year beginning January 1, 1951. If each dealer had purchased for $1,060 on April 1, 1950, a short-term municipal bond having a face obligation of $1,000 and maturing April 1, 1955, and had sold such bond on February 28, 1955, the adjustment under section 75 would be computed as follows:

	Dealer X	Dealer Y
Bond premium	$60	$60
Adjustment for holding period prior to Jan. 1, 1951	9	9
Amortizable bond premium to maturity, as adjusted	51	51
Amortizable bond premium per month	1	1
Total adjustments under section 22 (o), 1939 Code, for years 1951–53	36	None
Adjustment under section 75 for 1954..	12	None
Adjustment under section 75 for 1955..	2	50

§ 1.76 Statutory provisions; mortgages made or obligations issued by joint-stock land banks.

SEC. 76. *Mortgages made or obligations issued by joint-stock land banks.* All income (except interest) derived from mortgages made, or obligations issued, after May 28, 1938, by a joint-stock land bank shall (notwithstanding section 26 of the Federal Farm Loan Act; 12 U. S. C. 931–3) be included in gross income.

§ 1.77 Statutory provisions; commodity credit loans.

SEC. 77. *Commodity credit loans*—(a) *Election to include loans in income.*

Amounts received as loans from the Commodity Credit Corporation shall, at the election of the taxpayer, be considered as income and shall be included in gross income for the taxable year in which received.

(b) *Effect of election on adjustments for subsequent years.* If a taxpayer exercises the election provided for in subsection (a) for any taxable year, then the method of computing income so adopted shall be adhered to with respect to all subsequent taxable years unless with the approval of the Secretary or his delegate a change to a different method is authorized.

§ 1.77–1 Election to consider Commodity Credit Corporation loans as income.

A taxpayer who receives a loan from the Commodity Credit Corporation may, at his election, include the amount of such loan in his gross income for the taxable year in which the loan is received. If a taxpayer makes such an election (or has made such an election under section 123 of the Internal Revenue Code of 1939 or under section 223 (d) of the Revenue Act of 1939 (53 Stat. 897)), then for subsequent taxable years he shall include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Application for permission to change such method of accounting and the basis upon which the return is made shall be filed with the Commission of Internal Revenue, Washington 25, D. C., within 90 days after the beginning of the taxable year to be covered by the return.

§ 1.77–2 Effect of election to consider commodity credit loans as income.

(a) If a taxpayer elects or has elected under section 77, section 123 of the Internal Revenue Code of 1939, or section 223(d) of the Revenue Act of 1939 (53 Stat. 897), as amended, to include in his gross income the amount of a loan from the Commodity Credit Corporation for the taxable year in which it is received, then—

(1) No part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced to him as the loan, in which event such additional amount shall be included in the gross income of the taxpayer for the taxable year in which it is received, and

(2) No deductible loss to the taxpayer shall be recognized on account of any deficiency realized by the Commodity Credit Corporation on such loan if the taxpayer was relieved from liability for such deficiency.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, a taxpayer who elected for his taxable year 1952 to include in gross income amounts received as loans from the Commodity Credit Corporation, received as loans $500 in 1952, $700 in 1953, and $900 in 1954. In 1956 all the pledged commodity was sold by the Commodity Credit Corporation for an amount $100 and $200 less than the loans with respect to the commodity pledged in 1952 and 1953, respectively, and for an amount $150 greater than the loan with respect to the commodity pledged in 1954. A, in making his return for 1956, shall include in gross income the sum of $150 if it is received during that year, but will not be allowed a deduction for the deficiencies of $100 and $200 unless he is required to satisfy such deficiencies and does satisfy them during that year.

Items Specifically Excluded From Gross Income

§ 1.101 Statutory provisions; certain death benefits.

Sec. 101. *Certain death benefits*—(a) *Proceeds of life insurance contracts payable by reason of death*—(1) *General rule.* Except as otherwise provided in paragraph (2) and in subsection (d), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

(2) *Transfer for valuable consideration.* In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer—

(A) If such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

(B) If such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

(b) *Employees' death benefits*—(1) *General rule.* Gross income does not include amounts received (whether in a single sum or otherwise) by the beneficiaries or the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid by reason of the death of the employee.

(2) *Special rules for paragraph (1)*—(A) *$5,000 limitation.* The aggregate amounts excludable under paragraph (1) with respect to the death of any employee shall not exceed $5,000.

(B) *Nonforfeitable rights.* Paragraph (1) shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (other than total distributions payable, as defined in section 402 (a) (3), which are paid to a distributee, by a stock bonus, pension, or profit-sharing trust described in section 401 (a) which is exempt from tax under section 501 (a), or under an annuity contract under a plan which meets the requirements of paragraphs (3), (4), (5), and (6) of section 401 (a), within one taxable year of the distributee by reason of the employee's death).

(C) *Joint and survivor annuities.* Paragraph (1) shall not apply to amounts received by a surviving annuitant under a joint and survivor's annuity contract after the first day of the first period for which an amount was received as an annuity by the employee (or would have been received if the employee had lived).

(D) *Other annuities.* In the case of any amount to which section 72 (relating to annuities, etc.) applies, the amount which is excludable under paragraph (1) (as modified by the preceding subparagraphs of this paragraph) shall be determined by reference to the value of such amount as of the day on which the employee died. Any amount so excludable under paragraph (1) shall, for purposes of section 72, be treated as additional consideration paid by the employee.

(c) *Interest.* If any amount excluded from gross income by subsection (a) or (b) is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.

(d) *Payment of life insurance proceeds at a date later than death*—(1) *General rule.* The amounts held by an insurer with respect to any beneficiary shall be prorated (in accordance with such regulations as may be prescribed by the Secretary or his delegate) over the period or periods with respect to which such payments are to be made. There shall be excluded from the gross income of such beneficiary in the taxable year received—

(A) Any amount determined by such proration, and

(B) In the case of the surviving spouse of the insured, that portion of the excess of the amounts received under one or more agreements specified in paragraph (2) (A) (whether or not payment of any part of such amounts is guaranteed by the insurer) over the amount determined in subparagraph (A) of this paragraph which is not greater than $1,000 with respect to any insured.

Gross income includes, to the extent not excluded by the preceding sentence, amounts received under agreements to which this subsection applies.

(2) *Amount held by an insurer.* An amount held by an insurer with respect to any beneficiary shall mean an amount to which subsection (a) applies which is—

(A) Held by any insurer under an agreement provided for in the life insurance contract, whether as an option or otherwise, to pay such amount on a date or dates later than the death of the insured, and

(B) Is equal to the value of such agreement to such beneficiary

(i) As of the date of death of the insured (as if any option exercised under the life insurance contract were exercised at such time), and

(ii) As discounted on the basis of the interest rate and mortality tables used by the insurer in calculating payments under the agreement.

(3) *Surviving spouse.* For purposes of this subsection, the term "surviving spouse" means the spouse of the insured as of the date of death, including a spouse legally separated but not under a decree of absolute divorce.

(4) *Application of subsection.* This subsection shall not apply to any amount to which subsection (c) is applicable.

(e) *Alimony, etc., payments*—(1) *In general.* This section shall not apply to so much of any payment as is includible in the gross income of the wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.).

(2) *Cross reference.* For definition of "wife", see section 7701 (a) (17).

(f) *Effective date of section.* This section shall apply only to amounts received by reason of the death of an insured or an employee occurring after the date of enactment of this title. Section 22 (b) (1) of the Internal Revenue Code of 1939 shall apply to amounts received by reason of the death of an insured or an employee occurring on or before such date.

§ 1.101–1 Exclusion from gross income of proceeds of life insurance contracts payable by reason of death.

(a) *In general.* Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance pro-

ceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101 (b) and § 1.101–2. The exclusion from gross income allowed by section 101 (a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101 (a) (2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101 (c) (relating to amounts held under agreements to pay interest) or section 101 (d) (relating to amounts payable at a date later than death). See §§ 1.101–3 and 1.101–4. However, neither section 101 (c) nor section 101 (d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death. For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee under pension, profit-sharing, or stock bonus plans described in section 401 (a) and exempt under section 501 (a), or under annuity plans meeting the requirements of section 401 (a) (3), (4), (5), and (6), see also section 402 (a) and 403 (a) and the regulations thereunder. For the definition of a life insurance company, see section 801.

(b) *Transfers of life insurance policies.* (1) In the case of a transfer, by assignment or otherwise, of a life insurance policy or any interest therein for a valuable consideration, the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income is generally limited to the sum of (i) the actual value of the consideration for such transfer, and (ii) the premiums and other amounts subsequently paid by the transferee (see section 101 (a) (2) and example (1) of subparagraph (5) of this paragraph). However, this limitation on the amount excludable from the transferee's gross income does not apply (except in certain special cases involving a series of transfers), where the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest in the hands of the transferor (see section 101 (a) (2) (A) and examples (2) and (4) of subparagraph (5) of this paragraph). Neither does the limitation apply where the policy or interest therein is transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer (see section 101 (a) (2) (B)). For rules relating to gratuitous transfers, see subparagraph (2) of this paragraph. For special rules with respect to certain cases where a series of transfers is involved, see subparagraph (3) of this paragraph.

(2) In the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, as a general rule the amount of the proceeds attributable to such policy or interest which is excludable from the transferee's gross income under section 101 (a) is limited to the sum of (i) the amount which would have been excludable by the transferor (in accordance with this section) if no such transfer had taken place, and (ii) any premiums and other amounts subsequently paid by the transferee. See example (6) of subparagraph (5) of this paragraph. However, where the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred shall be excludable from the transferee's gross income (see section 101 (a) (2) (B) and example (7) of subparagraph (5) of this paragraph).

(3) In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration—

(i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—

(*a*) The actual value of the consideration paid by him, and

(*b*) The premiums and other amounts subsequently paid by him;

(ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;

(iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—

(*a*) The amount which would have been excludable by his transferor if no such transfer had taken place, and

(*b*) Any premiums and other amounts subsequently paid by the final transferee himself.

(4) For the purposes of section 101 (a) (2) and subparagraphs (1) and (3) of this paragraph, a "transfer for a valuable consideration" is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is inapplicable to any amounts received by the pledgee or assignee.

(5) The application of this paragraph may be illustrated by the following examples:

Example (*1*). A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon the life of B, and subsequently transfers the policy to C for $600. C receives the proceeds of $1,000 upon the death of B. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by C subsequent to the transfer.

Example (*2*). The X Corporation purchases for a single premium of $500 an insurance policy in the face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the Y Corporation.

Example (*3*). The facts are the same as in example (2) except that, prior to the death of A, the Y Corporation transfers the policy to the Z Corporation for $600. The Z Corporation receives the proceeds of $1,000 upon the death of A. The amount which the Z Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it.

Example (*4*). The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the M Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the M Corporation determined by reference to its basis in the hands of the Z Corporation). The M Corporation receives the proceeds of $1,000 upon the death of A. The amount which the M Corporation can exclude from its gross income is limited to $600 plus any premiums paid by the Z Corporation and the M Corporation subsequent to the transfer of the policy to the Z Corporation.

Example (*5*). The facts are the same as in example (3) except that, prior to the death of A, the Z Corporation transfers the policy to the N Corporation, in which A is a shareholder. The N Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the N Corporation.

Example (*6*). A pays premiums of $500 for an insurance policy in the face amount of $1,000 upon his own life, and subsequently transfers the policy to his wife B for $600. B later transfers the policy without consideration to C, who is the son of A and B. C receives the proceeds of $1,000 upon the death of A. The amount which C can exclude from his gross income is limited to $600 plus any premiums paid by B and C subsequent to the transfer of the policy to B.

Example (*7*). The facts are the same as in example (6) except that, prior to the death of A, C transfers the policy without consideration to A, the insured. A's estate receives the proceeds of $1,000 upon the

death of A. The entire $1,000 is to be excluded from the gross income of A's estate.

§ 1.101–2 Employees' death benefits.

(a) *In general.* (1) Section 101(b) states the general rule that amounts up to $5,000 which are paid to the beneficiaries or the estate of an employee, or former employee, by or on behalf of an employer and by reason of the death of the employee shall be excluded from the gross income of the recipient. This exclusion from gross income applies whether payment is made to the estate of the employee or to any beneficiary (individual, corporation, or partnership), whether it is made directly or in trust, and whether or not it is made pursuant to a contractual obligation of the employer. The exclusion applies whether payment is made in a single sum or otherwise, subject to the provisions of section 101 (c), relating to amounts held under an agreement to pay interest thereon (see § 1.101–3). The exclusion from gross income also applies to any amount not actually paid which is otherwise taxable to a beneficiary of an employee because it was made available as a distribution from an employee's trust.

(2) The exclusion does not apply to amounts constituting income payable to the employee during his life as compensation for his services, such as bonuses or payments for unused leave or uncollected salary, nor to certain other amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101 (b) (2) (B) and paragraph (d) of this section). Further, the exclusion does not apply to amounts received as an annuity under a joint and survivor annuity obligation where the employee was the primary annuitant and the annuity starting date occurred before the death of the employee (see section 101 (b) (2) (C) and paragraph (e) (1) (ii) of this section). In the case of amounts received by a beneficiary as an annuity (but not as a survivor under a joint and survivor annuity with respect to which the employee was the primary annuitant), the exclusion is applied indirectly by means of the provisions of section 72 and the regulations thereunder (see section 101 (b) (2) (D) and paragraph (e) (1) (iii) and (iv) of this section).

(3) The total amount excludable with respect to any employee may not exceed $5,000, regardless of the number of employers or the number of beneficiaries. For allocation of the exclusion among beneficiaries, see paragraph (c) of this section. For rules governing the taxability of benefits payable on the death of an employee under pension, profit-sharing, or stock bonus plans described in section 401 (a) and exempt under section 501 (a), or under annuity plans meeting the requirements of section 401 (a) (3), (4), (5), and (6), see also sections 402 (a) and 403 (a) and the regulations thereunder.

(b) *Payments under certain employee benefit plans.* Where a payment is made by reason of the death of an employee by an employer-provided welfare fund or a trust, including a stock bonus, pension, or profit-sharing trust described in section 401 (a), or by an insurance company (if such payment does not constitute "life insurance" within the purview of section 101 (a)), the payment shall be considered to have been made by or on behalf of the employer to the extent that it exceeds amounts contributed by, or deemed contributed by, the deceased employee. For provisions governing the taxability of distributions payable on the death of an employee participant under a trust described in section 401 (a) and exempt under section 501 (a), which has purchased annuity contracts, life insurance contracts, or retirement income contracts with life insurance protection, see paragraph (a) (4) of § 1.402 (a)–1. For provisions governing the taxability of distributions payable on the death of an employee under nontrusteed plans, see paragraphs (c) and (d) of § 1.403 (a)–1.

(c) *Allocation of the exclusion.* (1) Where the aggregate payments by or on behalf of an employer or employers as death benefits to the beneficiaries or the estate of a deceased employee exceed $5,000, the $5,000 exclusion shall be apportioned among them in the same proportion as the amount received by or the present value of the amount payable to each bears to the total death benefits paid or payable by or on behalf of the employer or employers.

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The M Corporation, the employer of A, a deceased employee who died November 30, 1954, makes payments in 1955 to the beneficiaries of A as follows: $5,000 to W, A's widow, $2,000 to B, the son of A, and $3,000 to C, the daughter of A. No other amounts are paid by any other employer of A to his estate or beneficiaries. By application of the apportionment rule stated above, W, the widow, will exclude $2,500 ($5,000/$10,000, or one-half, of $5,000); B, the son, will exclude $1,000 ($2,000/$10,000, or one-fifth, of $5,000); and C, the daughter, will exclude $1,500 ($3,000/$10,000, or three-tenths, of $5,000).

(d) *Nonforfeitable rights.* (1) Except as provided in subparagraph (3) of this paragraph, the exclusion provided by section 101 (b) does not apply to amounts with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living. Section 101 (b) (2) (B). For the purpose of section 101 (b) and this paragraph, an employee shall be considered to have had a nonforfeitable right with respect to—

(i) Any amount to which he would have been entitled—

(*a*) If he had made an appropriate election or demand, or

(*b*) Upon termination of his employment (see examples (5) and (6) of subparagraph (2) of this paragraph); or

(ii) The present value (immediately before his death) of—

(*a*) Amounts payable as an annuity (as defined in paragraph (b) of § 1.72–2, whether immediate or deferred) by or on behalf of the employer (see example (1) of subparagraph (2) of this paragraph), or

(*b*) Amounts which would have been so payable if the employee had terminated his employment and continued to live;
or

(iii) Any amount to the extent it is paid in lieu of amounts described in either subdivision (i) or (ii) of this subparagraph. See examples (2), (3), and (4) of subparagraph (2) of this paragraph.

For purposes of subdivision (iii) of this subparagraph, any amount paid in discharge of an obligation which arose solely because of the existence of a particular fact or circumstance subsequent to the employee's death shall not be considered an amount paid in lieu of amounts described in subdivision (i) or (ii) of this subparagraph. Subdivision (iii) of this subparagraph shall apply, however, to the extent indicated therein, to amounts payable without regard to any such contingency (to the extent that such amounts are equal to or less than those described in subdivision (i) and (ii) of this subparagraph which are not paid). See paragraph (e) (1) (iii) (*b*) of this section for rules with respect to finding the present value of an annuity immediately before the employee's death.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples, in which it is assumed that the plans are not "qualified" plans:

Example (1). A, who was a participant under the X Company pension plan, retired on December 31, 1953. He had made no contributions to the plan. Upon his retirement, he became entitled to monthly payments of $100 payable for life, or 120 months certain. A died on October 31, 1954, having received 10 monthly payments of $100 each. After his death, the monthly payments became payable to his estate for the remaining 110 months certain. No exclusion from gross income is allowed to A's estate (or any beneficiary who receives the right to such payments from the estate), since the employee's right to the monthly payments was nonforfeitable at the date of his death. It will be noted that in this example it is unnecessary to consider the present value of the annuity to A just before his death since the payments to be made include only those certain to be made in any event under the plan whether or not A continued to live.

Example (2). C, a participant under the Y Company pension plan, died on December 15, 1954, while actively in the employment of the company, survived by a widow and minor children. Because of his years of service, he would have been entitled to an annuity for life, his own contributions to the plan and interest thereon being guaranteed, if he had retired or terminated his employment at a time immediately before his death. The plan further provides that—(a) if, but only if, an employee is survived by a widow and minor children, his widow is to receive an annuity for her life without regard to whether or not the employee had begun his annuity; (b) any payments made with respect to his widow's annuity are to reduce the guaranteed amount to an equal extent; and (c) if the employee is not so survived, the guaranteed amount is payable to his beneficiary or estate, but no amount is payable to anyone with respect to what would have been the widow's annuity. In view of these provisions, that portion of the present value of the annuity payable to C's widow which exceeds the guaranteed amount shall be considered paid neither as an

amount, nor in lieu of an amount, which C had a nonforfeitable right to receive while living. The reason for this result is that the payment of such excess is contingent upon C's being survived by a widow and minor children, a circumstance existing subsequent to his death. Conversely, to the extent that the present value of the annuity payable to C's widow does not exceed the guaranteed amount, annuity payments attributable to such present value shall be considered paid in lieu of an amount which C had a nonforfeitable right to receive while living.

Example (3). D, a participant under the Y Company pension plan, died on January 1, 1955, while actively in the employment of the company. The Y Company plan provides that where an employee dies in service, the present value of the accumulated credits which he could have obtained at that time if he had instead separated from the service shall be paid in a single sum to his surviving spouse or to his estate if no widow survives him. The present value of D's accumulated credits, at the time of his death, was $10,000. However, the plan also provides that a surviving spouse may elect to take, in lieu of a single sum, an annuity the present value of which exceeds such sum by $2,500. D's widow elects to receive an annuity (the present value of which is $12,500). Therefore, $2,500 is an amount to which the exclusion of section 101 (b) and this section shall apply.

Example (4). A, an employee of the X Company, continues to work after reaching the normal retirement age of 60 years, although he could have retired at that age and obtained an annuity of $3,000 per year for his life. A is not entitled to any part of the annuity while he is employed and receiving compensation. A dies at the age of 67 while still in active employment. Since he had passed normal retirement age, his additional years of service did not entitle him to a larger annuity at age 67 than that which he could have obtained at age 60. However, the plan of the X Company provides that in the event of an employee's death prior to separation from the service, his widow is to be paid an annuity for her life in the same amount per year as that which the employee could have obtained if he had instead retired; but if no widow survives him, the present value of the annuity which the employee could have obtained at a time just before his death is to be paid to a named beneficiary or the estate of the employee. Assuming that the present value of the annuity to A's widow, whose age is 61, is $36,000 and the present value of the annuity which would have been payable to A at age 67 if he had then retired is $23,500, the present value of the widow's annuity, to the extent of $23,500, is an amount which is payable in lieu of amounts which the employee had a nonforfeitable right to receive while living because it does not exceed the value of his nonforfeitable rights and is not otherwise paid. On the other hand, the $12,500 excess of the value of the widow's annuity ($36,000) over the value of the employee's annuity ($23,500) is an amount to which section 101 (b) applies since the employee had no right to any part of it. If no other death benefits are payable, a $5,000 exclusion is available (see section 101 (b) (2) (D) and paragraph (e) of this section).

Example (5). The trustee of the X Corporation noncontributory profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee in case of termination of employment a 10-percent vested interest in the amount accumulated in his account for each year of participation in the plan. In case of death, the entire credit in the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for three years and the accumulation in his account was $8,000. After his death this amount is paid to his beneficiary. At the time of B's death, the amount distributable to him on account of termination of employment would have been $2,400 (30 percent of $8,000). The difference of $5,600 ($8,000 minus $2,400), payable to the beneficiary of B, is an amount payable solely by reason of B's death. Accordingly, $5,000 of the $5,600 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved). However, if it is assumed that the facts are the same as above, except that at the time of his death B has been a participant for 6 years, the amount distributable to him on account of termination of employment would have been $4,800 (60 percent of $8,000). The difference of $3,200 ($8,000 minus $4,800), payable to B's beneficiary, is an amount payable solely by reason of B's death. Accordingly, only $3,200 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved).

Example (6). The X Corporation instituted a trust, forming part of a pension plan, for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that after 10 or more years of service and attaining the age of 55, an employee can elect to retire and receive benefits before the normal retirement date contingent upon the employer's approval. If he retires without the employer's consent, or voluntarily leaves the company, no benefits are or will be payable. The plan further provides that if the employee is involuntarily separated or dies before retirement, he or his beneficiary, respectively, will receive a percentage of the reserve provided for the employee in the trust fund on the following basis: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. A, an employee of the X Corporation for 17 years, died at the age of 56 while in the employ of the corporation. At the time of his death, $15,000 was the reserve provided for him in the trust. His beneficiary receives $7,500, an amount equal to 50 percent of the reserve provided for A's retirement; accordingly, $5,000 of the $7,500 may be excluded from the gross income of the beneficiary receiving such payment (assuming no other death benefits are involved) since A, prior to his death, had only a forfeitable right to receive $7,500.

(3) (i) Notwithstanding the rule stated in subparagraph (1) of this paragraph and illustrated in subparagraph (2) of this paragraph, the exclusion from gross income provided by section 101 (b) applies to the receipt of certain amounts, paid under "qualified" plans, with respect to which the deceased employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (see section 101 (b) (2) (B)). The payments to which this exclusion applies are—

(*a*) "Total distributions payable" by a stock bonus, pension, or profit-sharing trust described in section 401 (a) which is exempt from tax under section 501 (a), and

(*b*) "Total amounts" paid under an annuity contract under a plan meeting the requirements of section 401 (a) (3), (4), (5), and (6),

provided such distributions or amounts are paid in full within one taxable year of the distributee (see example (3) of subdivision (ii) of this subparagraph). For the purpose of applying section 101 (b), "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death, either before or after separation from the service (see section 402 (a) (3) (C), the regulations thereunder, and examples (2) and (4) of subdivision (ii) of this subparagraph); and "total amounts" means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death, either before or after separation from the service (see section 403 (a) (2) (B), the regulations thereunder, and example (1) of subdivision (ii) of this subparagraph).

(ii) The application of the provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). The widow of an employee elects, under a noncontributory "qualified" plan, to receive in a lump sum the present value of the annuity which C, the deceased employee, could have obtained at a time just before his death if he had retired at that time. Such present value is $6,000. Of this amount, $5,000 is excludable from the widow's gross income despite the fact that C had a nonforfeitable right to the amount in lieu of which the payment is made, since such payment is an amount to which subdivision (i) of this subparagraph applies (assuming no other death benefits are involved).

Example (2). The trustee of the X Corporation noncontributory, "qualified", profit-sharing plan is required under the provisions of the plan to pay to the beneficiary of B, an employee of the X Corporation who died on July 1, 1955, the benefit due on account of the death of B. The provisions of the profit-sharing plan give each participating employee, in case of termination of employment, a 10 percent vested interest in the amount accumulated in his account for each year of participation in the plan, but, in case of death, the entire credit to the participant's account is to be paid to his beneficiary. At the time of B's death, he had been a participant for five years. The accumulation in his account was $8,000, and the amount which would have been distributable to him in the event of termination of employment was $4,000 (50 percent of $8,000). After his death, $8,000 is paid to his beneficiary in a lump sum. (It may be noted that these are the same facts as in example (5) of subparagraph (2) of this paragraph except that the employee has been a participant for five years instead of three and the plan is a "qualified" plan.) It is immaterial that the employee had a nonforfeitable right to $4,000, because the payment of the $8,000 to the beneficiary is the payment of the "total distributions payable" within one taxable year of the distributee to which subdivision (i) of this subparagraph applies. Assuming no other death benefits are involved, the beneficiary may exclude $5,000 of the $8,000 payment from gross income.

Example (3). The facts are the same as in example (2) except that the beneficiary is entitled to receive only the $4,000 to which the employee had a nonforfeitable right and elects, 30 days after B's death, to receive it over a period of ten years. Since the "total distributions payable" are not paid within one taxable year of the distributee, no exclusion from gross income is allowable with respect to the $4,000.

Example (4). The X Corporation instituted a trust, forming part of a "qualified" profit-sharing plan for its employees, the cost thereof being borne entirely by the corporation. The plan provides, in part, that if, after 10 or more years of service, an employee leaves the employ of the corporation, either voluntarily or involuntarily, before retirement, a percentage of the reserve provided for the employee in the trust fund will be paid to the employee as follows: 10 to 15 years of service, 25 percent; 15 to 20 years of service, 50 percent; 20 to 25 years of service, 75 percent; 25 or more years of service, 100 percent. The plan further provides that if an employee dies before reaching retirement age, his beneficiary will receive a percentage of the reserve provided for the employee in the trust fund, on the same basis as shown in the preceding sentence. A, an employee of the X Corporation for 17 years, died before attaining retirement age while in the employ of the corporation. At the time of his death, $15,000 was the reserve provided for him in the trust fund. His beneficiary receives $7,500 in a lump sum, an amount equal to 50 percent of the reserve provided for A's retirement. The beneficiary may exclude from gross income (assuming no other death benefits are involved) $5,000 of the $7,500, since the latter amount constitutes "total distributions payable" paid within one taxable year of the distributee, to which subdivision (i) of this subparagraph applies.

(e) *Annuity payments.* (1) Where death benefits are paid in the form of annuity payments, the following rules shall govern for purposes of the exclusion provided in section 101 (b):

(i) The exclusion from gross income provided by section 101 (b) does not apply to amounts, paid as an annuity, with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or to amounts paid as an annuity in lieu thereof. See paragraph (d) of this section.

(ii) Under section 101 (b) (2) (C), no exclusion is allowable for amounts received by a surviving annuitant under a joint and survivor's annuity contract if the annuity starting date (as defined in section 72 (c) (4) and paragraph (b) of § 1.72–4) occurs before the death of the employee. If the annuity starting date occurs after the death of the employee, the joint and survivor's annuity contract shall be treated as an annuity to which section 101 (b) (2) (D) applies. See subdivision (iii) of this subparagraph.

(iii) (*a*) Subject to the other limitations stated in section 101 (b) and in this section (see section 101 (b) (2) (D)), the amount to which the exclusion of section 101 (b) shall apply, with respect to "amounts received as an annuity" (as defined in paragraph (b) of § 1.72–2) shall be the amount by which the present value of the annuity to be paid to the beneficiary, computed as of the date of the employee's death, exceeds the value (if any) of whichever of the following is the larger:

(*1*) Amounts contributed by the employee (determined in accordance with the provisions of section 72 and the regulations thereunder), or

(*2*) Amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, or amounts paid in lieu thereof (see paragraph (d) of this section).

(*b*) The present value of an annuity (immediately before the death of the employee), to the employee, or (immediately after the death of the employee), to his estate or beneficiary, shall be determined as follows:

(*1*) In the case of an annuity paid by an insurance company or by an organization (other than an insurance company) regularly engaged in issuing annuity contracts with an insurance company as the coinsurer or reinsurer of the obligations under the contract, by use of the discount interest rates and mortality tables used by the insurance company involved to determine the installment benefits;

(*2*) In the case of an annuity paid by an organization (other than an insurance company and other than an organization described in (*1*) of this subdivision) regularly engaged in issuing annuity contracts, by reference to the cost of a comparable contract purchased from an insurance company; and

(*3*) In the case of an annuity to which neither (*1*) nor (*2*) of this subdivision is applicable, by use of the appropriate tables in paragraph (f) of § 20.2031–7 of this chapter (Estate Tax Regulations) as supplemented by "Actuarial Values for Estate and Gift Tax" (Internal Revenue Service Publication No. 11, Rev. 5–59.

(iv) Any amount subject to section 101 (b) (2) (D) which is excludable under section 101 (b) (see subdivision (iii) of this subparagraph) shall, for purposes of section 72, be treated as additional consideration paid by the employee. See paragraph (b) of § 1.72–8.

(v) Where more than one beneficiary, or more than one death benefit, is involved, the exclusion provided by section 101 (b) shall be apportioned to the various beneficiaries and benefits in accordance with the proportion that the present value of each benefit bears to the total present value of all the benefits.

(2) The application of the principles of this paragraph may be illustrated by the following examples:

Example (*1*). (i) Under the plan of the X Corporation, W, who is the widow of employee A, and who is 55 years old at the time of A's death, is entitled to an immediate annuity of $2,000 per year during her life and C, the minor child of A, is entitled to receive $1,000 per year for 15 years. A made no contributions under the plan and died while still employed by the X Corporation. At the time of A's death, the amount in his account is $18,000. Under the terms of the plan, this amount would have been distributable to him on account of voluntary termination of employment, but would not have been payable after his death except in the form of the annuities just described. This amount, accordingly, constitutes a nonforfeitable interest in lieu of which the annuities are paid. The exclusion does not apply, except to the extent that the present value of the annuities exceeds $18,000, whether or not the plan is "qualified", since the total of the amount in A's account will not be paid within one taxable year of the distributees. See subparagraph (1) (i) of this paragraph.

(ii) The computation of the exclusion applicable to the interests of W and C (assuming that the payments will not be made by an insurance company or some other organization regularly engaged in issuing annuity contracts) is, by application of the tables in paragraph (f) of § 20.2031–7 of this chapter (Estate Tax Regulations), as follows: The present value of W's interest is $26,243.60, determined by multiplying the annual payment of $2,000 by 13.1218 (the factor in Table I for a person aged 55); the present value of C's interest is $11,517.40, determined by multiplying the yearly payment of $1,000 by 11.5174 (the factor in Table II for payments for a term certain of 15 years). The present value of both annuities is $37,761 and (assuming no other death benefits are involved), the total amount excludable is $5,000, because the total present value of the annuities exceeds the employee's nonforfeitable interest by more than $5,000 ($37,761 minus $18,000 equal $19,761). The exclusion allocable to W's interest is $26,243.60/$37,761 times $5,000, or $3,474.96; the exclusion allocable to C's interest is $11,517.40/$37,761 times $5,000, or $1,525.04. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

Example (*2*). The facts are the same as in example (1), except that the nonforfeitable interest of A, at the time of his death, amounted to $33,761. Since the present value of both annuities ($37,761) exceeds the value of such nonforfeitable interest by only $4,000, the latter amount is the total amount excludable from the gross income of the beneficiaries. This $4,000 exclusion is to be divided in the same proportions as those indicated in example (1). Thus, the exclusion allocable to W's interest is $26,243.60/$37,761 times $4,000, or $2,779.97; and the exclusion allocable to the interest of C is $11,517.40/$37,761 times $4,000, or $1,220.03. That portion of the death benefit exclusion as so determined for each beneficiary is to be treated as consideration paid by the employee for purposes of section 72.

§ 1.101–3 Interest payments.

(a) *Applicability of section 101(c).* Section 101(c) provides that if any amount excluded from gross income by section 101(a) (relating to life insurance proceeds) or section 101(b) (relating to employees' death benefits) is held under an agreement to pay interest thereon, the interest payments shall be included in gross income. This provision applies to payments made (either by an insurer or by or on behalf of an employer) of interest earned on any amount so excluded from gross income which is held without substantial diminution of the principal amount during the period when such interest payments are being made or credited to the beneficiaries or estate of the insured or the employee. For example, if a monthly payment is $100, of which $99 represents interest and $1 represents diminution of the principal amount, the principal amount shall be considered held under an agreement to pay interest thereon and the interest payment shall be included in the gross income of the recipient. Section 101 (c) applies whether the election to have an amount held under an agreement to pay interest thereon is made by the insured or employee or by his beneficiaries or estate, and whether or not an interest rate is explicitly stated in the agreement. Section 101 (d), relating to the payment of life insurance proceeds at a date later than death, shall not apply to any amount to which section 101 (c) applies. See section 101 (d) (4).

(b) *Determination of "present value".* For the purpose of determining whether

section 101 (c) or section 101 (d) applies

section 101 (c) or section 101 (d) applies, the present value (at the time of the insured's death) of any amount which is to be paid at a date later than death shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the size of the payments to be made.

§ 1.101–4 Payment of life insurance proceeds at a date later than death.

(a) *In general.* (1) (i) Section 101(d) states the provisions governing the exclusion from gross income of amounts (other than those to which section 101 (c) applies) received under a life insurance contract and paid by reason of the death of the insured which are paid to a beneficiary on a date or dates later than the death of the insured. However, if the amounts payable as proceeds of life insurance to which section 101 (a) (1) applies cannot in any event exceed the amount payable at the time of the insured's death, such amounts are fully excludable from the gross income of the recipient (or recipients) without regard to the actual time of payment and no further determination need be made under this section. Section 101 (d) (1) (A) provides an exclusion from gross income of any amount determined by a proration, under applicable regulations, of "an amount held by an insurer with respect to any beneficiary". The quoted phrase is defined in section 101 (d) (2). For the regulations governing the method of computation of this proration, see paragraphs (c) through (f) of this section. The prorated amounts are to be excluded from the gross income of the beneficiary regardless of the taxable year in which they are actually received (see example (2) of subparagraph (2) of this paragraph).

(ii) Section 101 (d) (1) (B) provides an additional exclusion where life insurance proceeds are paid to the surviving spouse of an insured. For purposes of this exclusion, the term "surviving spouse" means the spouse of the insured as of the date of death, including a spouse legally separated, but not under a decree of absolute divorce (section 101 (d) (3)). To the extent that the total payments, under one or more agreements, made in excess of the amounts determined by proration under section 101 (d) (1) (A) do not exceed $1,000 in the taxable year of receipt, they shall be excluded from the gross income of the surviving spouse (whether or not payment of any part of such amounts is guaranteed by the insurer). Amounts excludable under section 101 (d) (1) (B) are not "prorated" amounts.

(2) The principles of this paragraph may be illustrated by the following examples:

Example (1). A surviving spouse elects to receive all of the life insurance proceeds with respect to one insured, amounting to $150,000, in ten annual installments of $16,500 each, based on a certain guaranteed interest rate. The prorated amount is $15,000 ($150,000÷10). As the second payment, the insurer pays $17,850, which exceeds the guaranteed payment by $1,350 as the result of earnings of the insurer in excess of those required to pay the guaranteed installments. The surviving spouse shall include $1,850 in gross income and exclude $16,000—determined in the following manner:

Fixed payment (including guaranteed interest)	$16,500
Excess interest	1,350
Total payment	17,850
Prorated amount	15,000
Excess over prorated amount	2,850
Annual excess over prorated amount excludable under section 101 (d) (1) (B)	1,000
Amount includible in gross income	1,850

Example (2). Assume the same facts as in example (1), except that the third and fourth annual installments, totalling $33,000 (2×$16,500), are received in a single subsequent taxable year of the surviving spouse. The prorated amount of $15,000 of each annual installment, totalling $30,000, shall be excluded even though the spouse receives more than one annual installment in the single subsequent taxable year. However, the surviving spouse is entitled to only one exclusion of $1,000 under section 101 (d) (1) (B) for each taxable year of receipt. The surviving spouse shall include $2,000 in her gross income for the taxable year with respect to the above installment payments ($33,000 less the sum of $30,000 plus $1,000).

Example (3). Assume the same facts as in example (1), except that the surviving spouse dies before receiving all ten annual installments and the remaining installments are paid to her estate or beneficiary. In such a case, $15,000 of each installment would continue to be excludable from the gross income of the recipient, but any amounts received in excess thereof would be fully includible.

(b) *Amount held by an insurer.* (1) For the purpose of the proration referred to in section 101 (d) (1), an "amount held by an insurer with respect to any beneficiary" means an amount equal to the present value to such beneficiary (as of the date of death of the insured) of an agreement by the insurer under a life insurance policy (whether as an option or otherwise) to pay such beneficiary an amount or amounts at a date or dates later than the death of the insured (section 101 (d) (2)). The present value of such agreement is to be computed as if the agreement under the life insurance policy had been entered into on the date of death of the insured, except that such value shall be determined by the use of the mortality table and interest rate used by the insurer in calculating payments to be made to the beneficiary under such agreement. Where an insurance policy provides an option for the payment of a specific amount upon the death of the insured in full discharge of the contract, such lump sum is the amount held by the insurer with respect to all beneficiaries (or their beneficiaries) under the contract. See, however, paragraph (e) of this section.

(2) In the case of two or more beneficiaries, the "amount held by the insurer" with respect to each beneficiary depends on the relationship of the different benefits payable to such beneficiaries. Where the amounts payable to two or more beneficiaries are independent of each other, the "amount held by the insurer with respect to each beneficiary" shall be determined and prorated over the periods involved independently. Thus, if a certain amount per month is to be paid to A for his life, and, concurrently, another amount per month is to be paid to B for his life, the "amount held by the insurer" shall be determined and prorated for both A and B independently, but the aggregate shall not exceed the total present value of such payments to both. On the other hand, if the obligation to pay B was contingent on his surviving A, the "amount held by the insurer" shall be considered an amount held with respect to both beneficiaries simultaneously. Furthermore, it is immaterial whether B is a named beneficiary or merely the ultimate recipient of payments for a term of years. For the special rules governing the computation of the proration of the "amount held by an insurer" in determining amounts excludable under the provisions of section 101 (d), see paragraphs (c) to (f), inclusive, of this section.

(3) Notwithstanding any other provision of this section, if the policy was transferred for a valuable consideration, the total "amount held by an insurer" cannot exceed the sum of the consideration paid plus any premiums or other consideration paid subsequent to the transfer if the provisions of section 101 (a) (2) and paragraph (b) of § 1.101–1 limit the excludability of the proceeds to such total.

(c) *Treatment of payments for life to a sole beneficiary.* If the contract provides for the payment of a specified lump sum, but, pursuant to an agreement between the beneficiary and the insurer, payments are to be made during the life of the beneficiary in lieu of such lump sum, the lump sum shall be divided by the life expectancy of the beneficiary determined in accordance with the mortality table used by the insurer in determining the benefits to be paid. However, if payments are to be made to the estate or beneficiary of the primary beneficiary in the event that the primary beneficiary dies before receiving a certain number of payments or a specified total amount, such lump sum shall be reduced by the present value (at the time of the insured's death) of amounts which may be paid by reason of the guarantee, in accordance with the provisions of paragraph (e) of this section, before making this calculation. To the extent that payments received in each taxable year do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" and are excludable from the gross income of the beneficiary without regard to whether he lives beyond the life expectancy used in making the calculation. If the contract in question does not provide for the payment of a specific lump sum upon the death of the insured as one of the alternative methods of payment, the present value (at the time of the death of the insured) of the payments to be made the beneficiary, determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid, shall be used in the above calculation in lieu of a lump sum.

(d) *Treatment of payments to two or more beneficiaries*—(1) *Unrelated payments.* If payments are to be made to two or more beneficiaries, but the payments to be made to each are to be made without regard to whether or not payments are made or continue to be made to the other beneficiaries, the present value (at the time of the insured's death) of such payments to each beneficiary shall be determined independently for each such beneficiary. The present value so determined shall then be divided by the term for which the payments are to be made. If the payments are to be made for the life of the beneficiary, the divisor shall be the life expectancy of the beneficiary. To the extent that payments received by a beneficiary do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether he lives beyond any life expectancy used in making the calculation. For the purpose of the calculation described above, both the "present value" of the payments to be made periodically and the "life expectancy" of the beneficiary shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If payments are to be made to the estate or beneficiary of a primary beneficiary in the event that such beneficiary dies before receiving a certain number of payments or a specified total amount, the "present value" of payments to such beneficiary shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(2) *Related payments.* If payments to be made to two or more beneficiaries are in the nature of a joint and survivor annuity (as described in paragraph (b) of § 1.72–5), the present value (at the time of the insured's death) of the payments to be made to all such beneficiaries shall be divided by the life expectancy of such beneficiaries as a group. To the extent that the payments received by a beneficiary do not exceed the amount found from the above calculation, they are "prorated amounts" of the "amount held by an insurer" with respect to such beneficiary and are excludable from the gross income of the beneficiary without regard to whether all the beneficiaries involved live beyond the life expectancy used in making the calculation. For the purpose of the calculation described above, both the "present value" of the payments to be made periodically and the "life expectancy" of all the beneficiaries as a group shall be determined in accordance with the interest rate and mortality table used by the insurer in determining the benefits to be paid. If the contract provides that certain payments are to be made in the event that all the beneficiaries of the group die before a specified number of payments or a specified total amount is received by them, the present value of payments to be made to the group shall not include the present value (at the time of the insured's death) of amounts which may be paid by reason of such a guarantee. See paragraph (e) of this section.

(3) *Payments to secondary beneficiaries.* Payments made by reason of the death of a beneficiary (or beneficiaries) under a contract providing that such payments shall be made in the event that the beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount shall be excluded from the gross income of the recipient to the extent that such payments are made solely by reason of such guarantee.

(e) *Treatment of present value of guaranteed payments.* In the case of payments which are to be made for a life or lives under a contract providing that further amounts shall be paid upon the death of the primary beneficiary (or beneficiaries) in the event that such beneficiary (or beneficiaries) die before receiving a specified number of payments or a specified total amount, the present value (at the time of the insured's death) of all payments to be made under the contract shall not include, for purposes of prorating the amount held by the insurer, the present value of the payments which may be made to the estate or beneficiary of the primary beneficiary. In such a case, any lump sum amount used to measure the value of the amount held by an insurer with respect to the primary beneficiary must be reduced by the value at the time of the insured's death of any amounts which may be paid by reason of the guarantee provided for a secondary beneficiary or the estate of the primary beneficiary before prorating such lump sum over the life or lives of the primary beneficiaries. Such present value (of the guaranteed payment) shall be determined by the use of the interest rate and mortality tables used by the insurer in determining the benefits to be paid.

(f) *Treatment of payments not paid periodically.* Payments made to beneficiaries other than periodically shall be included in the gross income of the recipients, but only to the extent that they exceed amounts payable at the time of the death of the insured to each such beneficiary or, where no such amounts are specified, the present value of such payments at that time.

(g) *Examples.* The principles of this section may be illustrated by the following examples:

Example (1). A life insurance policy provides for the payment of $20,000 in a lump sum to the beneficiary at the death of the insured. Upon the death of the insured, the beneficiary elects an option to leave the proceeds with the company for five years and then receive payment of $24,000, having no claim of right to any part of such sum before the entire five years have passed. Upon the payment of the larger sum, $24,000, the beneficiary shall include $4,000 in gross income and exclude $20,000 therefrom. If it is assumed that the same insurer has determined the benefits to be paid, the same result would obtain if no lump sum amount were provided for at the death of the insured and the beneficiary were to be paid $24,000 five years later. In neither of these cases would the surviving spouse be able to exclude any additional amount from gross income since both cases involve an amount held by an insurer under an agreement to pay interest thereon to which section 101 (c) applies, rather than an amount to be paid periodically after the death of the insured to which section 101 (d) applies.

Example (2). A life insurance policy provides that $1,200 per year shall be paid the sole beneficiary (other than a surviving spouse) until a fund of $20,000 and interest which accrues on the remaining balance is exhausted. A guaranteed rate of interest is specified, but excess interest may be credited according to the earnings of the insurer. Assuming that the fund will be exhausted in 20 years if only the guaranteed interest is actually credited, the beneficiary shall exclude $1,000 of each installment received ($20,000 divided by 20) and any installments received, whether by the beneficiary or his estate or beneficiary, in excess of 20 shall be fully included in the gross income of the recipient. If, instead, the excess interest were to be paid each year, any portion of each installment representing an excess over $1,000 would be fully includible in the recipient's gross income. Thus, if an installment of $1,350 were received, $350 of it would be included in gross income.

Example (3). Assume that the sole life insurance policy of a decedent provides only for the payment of $5,000 per year for the life of his surviving spouse, beginning with the insured's death. If the present value of the proceeds, determined by reference to the interest rate and the mortality table used by the insurance company, is $60,000, and such beneficiary's life expectancy is 20 years, $3,000 of each $5,000 payment ($60,000 divided by 20) is excludable as the prorated portion of the "amount held by an insurer". For each taxable year in which a payment is made, an additional $1,000 is excludable from the gross income of the surviving spouse. Hence, if she receives only one $5,000 payment in her taxable year, only $1,000 is includible in her gross income in that year with respect to such payment ($5,000 less the total amount excludable, $4,000). Assuming that the policy also provides for payments of $2,000 per year for 10 years to the daughter of the insured, the present value of the payments to the daughter is to be computed separately for the purpose of determining the excludable portion of each payment to her. Assuming that such present value is $15,000, $1,500 of each payment of $2,000 received by the daughter is excludable from her gross income ($15,000 divided by 10). The remaining $500 shall be included in the gross income of the daughter.

Example (4). Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of $1,800 for each of their respective lives upon the death of the insured. The contract does not provide for payments to be made in any other manner. Assuming that the present value of the payments to be made to A, whose life expectancy according to the insurer's mortality table is 30 years, is $36,000, A shall exclude $1,200 of each payment received ($36,000 divided by 30). Assuming that the present value of the payments to be made to B, whose life expectancy according to the insurer's mortality table is 20 years, is $27,000, B shall exclude $1,350 of each payment received ($27,000 divided by 20).

Example (5). A life insurance policy provides for the payment of $76,500 in a lump sum to the beneficiary, A, at the death of the insured. Upon the insured's death, however, A selects an option for the payment of $2,000 per year for her life and for the same amount to be paid after her death to B, her daughter, for her life. Assuming that since A is 51 years of age and her daughter is 28 years of age, the insurer determined the amount of the payments by reference to a mortality table under which the life expect-

ancy for the lives of both A and B, joint and survivor, is 51 years, $1,500 of each $2,000 payment to either A or B ($76,500 divided by 51, or $1,500) shall be excluded from the gross income of the recipient. However, if A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude the entire payment of $2,000 in any taxable year in which she receives but one such payment because of the additional exclusion under section 101 (d) (1) (B).

Example (6). Beneficiaries A and B, neither of whom is the surviving spouse of the insured, are each to receive annual payments of $1,800 for each of their respective lives upon the death of the insured, but after the death of either, the survivor is to receive the payments formerly made to the deceased beneficiary until the survivor dies. Assuming that the life expectancy, joint and survivor, of A and B in accordance with the mortality table used by the insurer is 32 years and assuming that the total present value of the benefits to both (determined in accordance with the interest rate used by the insurer), is $80,000, A and B shall each exclude $1,250 of each installment of $1,800 ($80,000 divided by the life expectancy, 32, multiplied by the fraction of the annual payment payable to each, one-half) until the death of either. Thereafter, the survivor shall exclude $2,500 of each installment of $3,600 ($80,000 divided by 32).

Example (7). A life insurance policy provides for the payment of $75,000 in a lump sum to the beneficiary, A, at the death of the insured. A, upon the insured's death, however, selects an option for the payment of $4,000 per year for life, with a guarantee that any part of the $75,000 lump sum not paid to A before his death shall be paid to B (or his estate), A's beneficiary. Assuming that, under the criteria used by the insurer in determining the benefits to be paid, the present value of the guaranteed amount to B is $13,500 and that A's life expectancy is 25 years, the lump sum shall be reduced by the present value of the guarantee to B ($75,000 less $13,500, or $61,500) and divided by A's life expectancy ($61,500 divided by 25, or $2,460). Hence, $2,460 of each $4,000 payment is excludable from A's gross income. If A is the surviving spouse of the insured and no other contracts of insurance whose proceeds are to be paid to her at a date later than death are involved, A shall exclude $3,460 of each $4,000 payment from gross income in any taxable year in which but one such payment is received. Under these facts, if any amount is paid to B by reason of the fact that A dies before receiving a total of $75,000, the residue of the lump sum paid to B shall be excluded from B's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary, and is therefore entirely an "amount held by an insurer" paid at a date later than death (see paragraph (d) (3) of this section).

Example (8). Assume that an insurance policy does not provide for the payment of a lump sum, but provides for the payment of $1,200 per year for a beneficiary's life upon the death of the insured, and also provides that if ten payments are not made to the beneficiary before death a secondary beneficiary (whether named by the insured or by the first beneficiary) shall receive the remainder of the ten payments in similar installments. If, according to the criteria used by the insurance company in determining the benefits, the present value of the payments to the first beneficiary is $12,000 and the life expectancy of such beneficiary is 15 years, $800 of each payment received by the first beneficiary is excludable from gross income. Assuming that the same figures obtain even though the payments are to be made at the rate of $100 per month, the yearly exclusion remains the same unless more or less than twelve months' installments are received by the beneficiary in a particular taxable year. In such a case two-thirds of the total received in the particular taxable year with respect to such beneficiary shall be excluded from gross income. Under either of the above alternatives, any amount received by the second beneficiary by reason of the guarantee of ten payments is fully excludable from the beneficiary's gross income since it is wholly in lieu of the present value of such guarantee plus the present value of the payments to be made to the first beneficiary and is therefore entirely an "amount held by an insurer" paid at a date later than death (see paragraph (d) (3) of this section).

(h) *Limitations on application of section 101 (d).* Section 101 (d) shall not apply to interest payments on any amount held by an insurer under an agreement to pay interest thereon. See sections 101 (c) and 101 (d) (4), and § 1.101–3. See also paragraph (b) (3) of this section for a limitation on the amount which shall be considered an "amount held by an insurer" in the case of proceeds of life insurance which are paid subsequent to the transfer of the policy for a valuable consideration.

§ 1.101–5 Alimony, etc., payments.

Proceeds of life insurance policies paid by reason of the death of the insured to his separated wife, or payment excludable as death benefits under section 101 (b) paid to a deceased employee's separated wife, if paid to discharge legal obligations imposed by a decree of divorce or separate maintenance, by a written separation agreement executed after August 16, 1954, or by a decree of support entered after March 1, 1954, shall be included in the gross income of the separated wife if section 71 or 682 is applicable to the payments made. For definition of "wife", see section 7701 (a) (17) and the regulations thereunder.

§ 1.101–6 Effective date.

(a) The provisions of section 101 of the Internal Revenue Code of 1954 and §§ 1.101–1, 1.101–2, 1.101–3, 1.101–4, and 1.101–5 are applicable only with respect to amounts received by reason of the death of an insured or an employee occurring after August 16, 1954. In the case of such amounts, these sections are applicable even though the receipt of such amounts occurred in a taxable year beginning before January 1, 1954, to which the Internal Revenue Code of 1939 applies.

(b) Section 22 (b) (1) of the Internal Revenue Code of 1939 and the regulations pertaining thereto shall apply to amounts received by reason of the death of an insured or an employee occurring before August 17, 1954, regardless of the date of receipt.

§ 1.102 Statutory provisions; gifts and inheritances.

SEC. 102. *Gifts and inheritances*—(a) *General rule.* Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) *Income.* Subsection (a) shall not exclude from gross income—

(1) The income from any property referred to in subsection (a); or

(2) Where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

§ 1.102–1 Gifts and inheritances.

(a) *General rule.* Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74–1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances.* The income from any property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income.* If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663 (a) (1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of subchapter J.* Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663 (a) (1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor.* Section 102 is not intended to tax a donee upon the same income which

is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

§ 1.103 Statutory provisions; interest on certain governmental obligations.

SEC. 103. *Interest on certain governmental obligations*—(a) *General rule.* Gross income does not include interest on—

(1) The obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

(2) The obligations of the United States; or

(3) The obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States and if under the respective acts authorizing the issue of the obligations the interest is wholly exempt from the taxes imposed by this subtitle.

(b) *Exception.* Subsection (a) (2) shall not apply to interest on obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit, to the extent they represent deposits made before March 1, 1941), unless under the respective acts authorizing the issuance thereof such interest is wholly exempt from the taxes imposed by this subtitle.

(c) *Cross references.* For provisions relating to the taxable status of—

(1) Bonds and certificates of indebtedness authorized by the First Liberty Bond Act, see sections 1 and 6 of that Act (40 Stat. 35, 36; 31 U. S. C. 746, 755);

(2) Bonds issued to restore or maintain the gold reserve, see section 2 of the Act of March 14, 1900 (31 Stat. 46; 31 U. S. C. 408);

(3) Bonds, notes, certificates of indebtedness, and Treasury bills authorized by the Second Liberty Bond Act, see sections 4, 5 (b) and (d), 7, 18 (b), and 22 (d) of that Act, as amended (40 Stat. 290; 46 Stat. 20, 775; 40 Stat. 291, 1310; 55 Stat. 8; 31 U. S. C. 752a, 754, 747, 753, 757c);

(4) Bonds, notes, and certificates of indebtedness of the United States and bonds of the War Finance Corporation owned by certain nonresidents, see section 3 of the Fourth Liberty Bond Act, as amended (40 Stat. 1311, § 4; 31 U. S. C. 750);

(5) Certificates of indebtedness issued after February 4, 1910, see section 2 of the Act of that date (36 Stat. 192; 31 U. S. C. 769);

(6) Consols of 1930, see section 11 of the Act of March 14, 1900 (31 Stat. 48; 31 U. S. C. 751);

(7) Obligations and evidences of ownership issued by the United States or any of its agencies or instrumentalities on or after March 28, 1942, see section 4 of the Public Debt Act of 1941, as amended (c. 147, 61 Stat. 180; 31 U. S. C. 742a);

(8) Commodity Credit Corporation obligations, see section 5 of the Act of March 8, 1938 (52 Stat. 108; 15 U. S. C. 713a–5);

(9) Debentures issued by Federal Housing Administrator, see sections 204 (d) and 207 (1) of the National Housing Act, as amended (52 Stat. 14, 20; 12 U. S. C. 1710, 1713);

(10) Debentures issued to mortgagees by United States Maritime Commission, see section 1105 (c) of the Merchant Marine Act, 1936, as amended (52 Stat. 972; 46 U. S. C. 1275);

(11) Federal Deposit Insurance Corporation obligations, see section 15 of the Federal Deposit Insurance Act (64 Stat. 890; 12 U. S. C. 1825);

(12) Federal Home Loan Bank obligations, see section 13 of the Federal Home Loan Bank Act, as amended (49 Stat. 295, § 8; 12 U. S. C. 1433);

(13) Federal savings and loan association loans, see section 5 (h) of the Home Owners' Loan Act of 1933, as amended (48 Stat. 133; 12 U. S. C. 1464);

(14) Federal Savings and Loan Insurance Corporation obligations, see section 402 (c) of the National Housing Act (48 Stat. 1257; 12 U. S. C. 1725);

(15) Home Owners' Loan Corporation bonds, see section 4 (c) of the Home Owners' Loan Act of 1933, as amended (48 Stat. 644, c. 168; 12 U. S. C. 1463);

(16) Obligations of Central Bank for Cooperatives, production credit corporations, production credit associations, and banks for cooperatives, see section 63 of the Farm Credit Act of 1933 (48 Stat. 267; 12 U. S. C. 1138c);

(17) Panama Canal bonds, see section 1 of the Act of December 21, 1904 (34 Stat. 5; 31 U. S. C. 743), section 8 of the Act of June 28, 1902 (32 Stat. 484; 31 U. S. C. 744), and section 39 of the Tariff Act of 1909 (36 Stat. 117; 31 U. S. C. 745);

(18) Philippine bonds, etc., issued before the independence of the Philipipnes, see section 9 of the Philippine Independence Act (48 Stat. 463; 48 U. S. C. 1239);

(19) Postal savings bonds, see section 10 of the Act of June 25, 1910 (36 Stat. 817; 39 U. S. C. 760);

(20) Puerto Rican bonds, see section 3 of the Act of March 2, 1917, as amended (50 Stat. 844; 48 U. S. C. 745);

(21) Treasury notes issued to retire national bank notes, see section 18 of the Federal Reserve Act (38 Stat. 268; 12 U. S. C. 447);

(22) United States Housing Authority obligations, see sections 5 (c) and 20 (b) of the United States Housing Act of 1937 (50 Stat. 890, 898; 42 U. S. C. 1405, 1420);

(23) Virgin Islands insular and municipal bonds, see section 1 of the Act of October 27, 1949 (63 Stat. 940; 48 U. S. C. 1403).

§ 1.103–1 Interest upon obligations of a State, Territory, etc.

Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia is not includible in gross income. Obligations issued by or on behalf of the State, Territory, or possession of the United States, or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State, Territory, or possession of the United States, or a political subdivision thereof. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. The term "political subdivision", for purposes of this section, denotes any division of the State, Territory, or possession of the United States which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State, Territory, or possession of the United States. As thus defined, a political subdivision of a State, Territory, or possession of the United States may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State, Territory, or possession of the United States.

§ 1.103–2 Dividends from shares and stock of Federal agencies or instrumentalities.

(a) *Issued before March 28, 1942.* (1) Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U. S. C. 931), provides that Federal land banks and Federal land bank associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 7 of the Federal Reserve Act of December 23, 1913 (12 U. S. C. 531), provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 13 of the Federal Home Loan Bank Act (12 U. S. C. 1433) provides that the Federal Home Loan Bank including its franchise, its capital, reserves, and surplus, its advances, and its income shall be exempt from all taxation, except taxes upon real estate. Section 5 (h) of the Home Owners' Loan Act of 1933 (12 U. S. C. 1464 (h)) provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, Federal land bank associations, Federal home loan banks, and Federal reserve banks is not, in the case of stock issued before March 28, 1942, includible in gross income. Income consisting of dividends on share accounts of Federal savings and loan associations is includible in gross income but, in the case of shares issued before March 28, 1942, is not subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 (31 U. S. C. 742a) and paragraph (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see paragraph (b) of this section.

(2) Regardless of the exemption from income tax of dividends paid on the stock of Federal reserve banks, dividends paid by member banks are treated like dividends of ordinary corporations.

(3) Dividends on the stock of the central bank for cooperatives, the production credit corporations, production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933 (12 U.S.C. 1138), constitute income to the recipients, subject to both the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (12 U.S.C. 1138c)).

(b) *Issued on or after March 28, 1942.* (1) By virtue of the provisions of section 6 of the Public Debt Act of 1942 (31 U.S.C. 742a), the tax exemption provisions set forth in paragraph (a) of this section with respect to income consisting of dividends on stock of the Federal land banks, Federal land bank associations, and Federal reserve banks, or on share

accounts of Federal savings and loan associations, are not applicable in the case of dividends on such stock or shares issued on or after March 28, 1942.

(2) For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for. These rules may be illustrated by the following examples:

Example (1). A, the owner of an investment share account, consisting of 10 shares, in a Federal savings and loan association, has a single certificate issued before March 28, 1942, evidencing such ownership. In order that A may dispose of half of such shares, the association at his request issues, after March 27, 1942, two 5-share certificates in substitution for the 10-share certificate. The shares evidenced by the two new certificates are deemed to have been issued before March 28, 1942, the shares having been paid for before such date.

Example (2). The X Bank, a member of a Federal reserve bank, owns 50 shares of Federal reserve bank stock, evidenced by a single stock certificate issued before March 28, 1942. On December 31, 1942, the X Bank reduces the amount of its capital stock, as a result of which it is required to reduce the amount of its Federal reserve bank stock to 40 shares. It surrenders the 50-share certificate to the Federal reserve bank and receives a new 40-share certificate. The 40 shares evidenced by such certificate are deemed to have been issued before March 28, 1942. On December 31, 1948, the X Bank increases the amount of its capital stock, as a result of which it is required to purchase 10 additional shares of the Federal reserve bank stock. The Federal reserve bank issues a 10-share certificate evidencing ownership of the new shares. Of the 50 shares then owned by the X Bank, 40 were issued prior to March 28, 1942, and 10 were issued after March 27, 1942.

Example (3). A, the owner of a savings share account in the amount of $100 in a Federal savings and loan association, has a passbook containing a certificate issued prior to March 28, 1942, evidencing such ownership. Subsequent to March 27, 1942, A deposits $10,000 in the account. With respect to the $10,000 deposit, the share is deemed to have been issued after March 27, 1942.

§ 1.103–3 Interest upon notes secured by mortgages executed to Federal agencies or instrumentalities.

Section 26 of the Federal Farm Loan Act (12 U.S.C. 931), and section 210 of such act, as added by section 2 of the act of March 4, 1923 (12 U. S. C. 1111), provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

§ 1.103–4 Interest upon United States obligations.

(a) *Issued before March 1, 1941.* (1) Interest upon obligations of the United States issued on or before September 1, 1917, is exempt from tax. In the case of obligations issued by the United States after September 1, 1917, and in the case of obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States, the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented.

(2) Interest on Treasury bonds issued before March 1, 1941, is exempt from Federal income taxes except surtaxes imposed upon the income or profits of individuals, associations, or corporations. However, interest on an aggregate of not exceeding $5,000 principal amount of such bonds is also exempt from surtaxes. Interest in excess of the interest on an aggregate of not exceeding $5,000 principal amount of such bonds is subject to surtax and must be included in gross income.

(3) Interest credited to postal savings accounts upon moneys deposited before March 1, 1941, in postal savings banks is wholly exempt from income tax.

(b) *Issued on or after March 1, 1941.* (1) Under the provisions of sections 4 and 5 of the Public Debt Act of 1941 (31 U.S.C. 742a), interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal income tax except in respect of any such obligations which the Federal Maritime Board and Maritime Administration (formerly United States Maritime Commission) or the Federal Housing Administration has, before March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes hereof, under section 4 (a) of the Public Debt Act of 1941, a Territory and a possession of the United States (or any political subdivisions thereof), and the District of Columbia, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(2) In the case of obligations issued as the result of a refunding operation, as, for example, where a corporation exchanges bonds for previously issued bonds, the refunding obligations are deemed, for the purposes of this section, to have been issued at the time of the exchange rather than at the time the original bonds were issued.

§ 1.103–5 Treasury bond exemption in the case of trusts or partnerships.

(a) When the income of a trust is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries currently, each beneficiary is entitled to exemption as if he owned directly a proportionate part of the Treasury bonds held in trust. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trust, as the owner of the bonds held in trust, is entitled to the exemption on account of such ownership. In general, see sections 652 (b) and 662 (b) and the regulations thereunder.

(b) As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership. For rules relating to partially tax-exempt interest see section 702 (a) (7) and the regulations thereunder.

§ 1.103–6 Interest upon United States obligations in the case of nonresident aliens and foreign corporations, not engaged in business in the United States.

By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (31 U. S. C. 750), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (31 U. S. C. 750), the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued before March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in paragraph (b) of § 1.103–4.

§ 1.104 Statutory provisions; compensation for injuries or sickness.

SEC. 104. *Compensation for injuries or sickness*—(a) *In general.* Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) Amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) The amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness;

(3) Amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer); and

(4) Amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast or Geodetic Survey or the Public Health Service.

(b) *Gross references.* (1) For exclusion from employee's gross income of employer contributions to accident and health plans, see section 106.

(2) For exclusion of part of disability retirement pay from the application of subsection (a) (4) of this section, see section 402 (h) of the Career Compensation Act of 1949 (37 U. S. C. 272 (h)).

§ 1.104–1 Compensation for injuries or sickness.

(a) *In general.* Section 104(a) provides an exclusion from gross income with respect to certain amounts described in paragraphs (b), (c), (d) and (e) of this section, which are received for personal injuries or sickness, except to the extent that such amounts are attributable to (but not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder.

(b) *Amounts received under workmen's compensation acts.* Section 104 (a) (1) excludes from gross income amounts which are received by an employee under a workmen's compensation act (such as the Longshoremen's and Harbor Workers' Compensation Act, 33 U. S. C., c. 18), or under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment. Section 104 (a) (1) also applies to compensation which is paid under a workmen's compensation act to the survivor or survivors of a deceased employee. However, section 104 (a) (1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Section 104 (a) (1) also does not apply to amounts which are received as compensation for a nonoccupational injury or sickness nor to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workmen's compensation act or acts. See, however, §§ 1.105–1 through 1.105–5 for rules relating to exclusion of such amounts from gross income.

(c) *Damages received on account of personal injuries or sickness.* Section 104 (a) (2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

(d) *Accident or health insurance.* Section 104 (a) (3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). Similar treatment is also accorded to amounts received under accident or health plans and amounts received from sickness or disability funds. See section 105 (e) and § 1.105–5. If, therefore, an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104 (a) (3). See, however, section 213 and the regulations thereunder, as to the inclusion in gross income of amounts attributable to deductions allowed under section 213 for any prior taxable year. Section 104 (a) (3) also applies to amounts received by an employee for personal injuries or sickness from a fund which is maintained exclusively by employee contributions. Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees (on either a group or individual basis), the exclusion provided under section 104 (a) (3) does not apply to any amounts received by his employees through such fund or insurance. If the employer and his employees contribute to a fund or purchase insurance which pays accident or health benefits to employees, section 104 (a) (3) does not apply to amounts received thereunder by employees to the extent that such amounts are attributable to the employer's contributions. See § 1.105–1 for rules relating to the determination of the amount attributable to employer contributions. Although amounts paid by or on behalf of an employer to an employee for personal injuries or sickness are not excludable from the employee's gross income under section 104 (a) (3), they may be excludable therefrom under section 105. See §§ 1.105–1 through 1.105–5, inclusive.

(e) *Amounts received as pensions, etc., for certain personal injuries or sickness.* Section 104 (a) (4) excludes from gross income amounts which are received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, or in the Coast and Geodetic Survey, or the Public Health Service. Section 104 (a) (4) is applicable to a pension, annuity, or similar allowance received by the beneficiaries of an individual by reason of the death of such individual due to a personal injury or sickness resulting from service in the armed forces of any country, or the Coast and Geodetic Survey, or the Public Health Service. For purposes of this section, that part of the retired pay of a member of an armed force, computed under formula No. 1 or 2 of 10 U.S.C. 1401, or under 10 U.S.C. 1402(d), on the basis of years of service, which exceeds the retired pay that he would receive if it were computed on the basis of percentage of disability is not considered as a pension, annuity, or similar allowance for personal injury, or sickness, resulting from active service in the armed forces, or in the Coast and Geodetic Survey, or the Public Health Service (see 10 U.S.C. 1403 (formerly section 402(h) of the Career Compensation Act of 1949)).

§ 1.105 Statutory provisions; amounts received under accident and health plans.

SEC. 105. *Amounts received under accident and health plans*—(a) *Amounts attributable to employer contributions.* Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

(b) *Amounts expended for medical care.* Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213 (e)) of the taxpayer, his spouse, and his dependents (as defined in section 152).

(c) *Payments unrelated to absence from work.* Gross income does not include amounts referred to in subsection (a) to the extent such amounts—

(1) Constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and

(2) Are computed with reference to the nature of the injury without regard to the period the employee is absent from work.

(d) *Wage continuation plans.* Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. In the case of a period during which the employee is absent from work on account of sickness, the preceding sentence shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid.

(e) *Accident and health plans.* For purposes of this section and section 104—

(1) Amounts received under an accident or health plan for employees, and

(2) Amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia,

shall be treated as amounts received through accident or health insurance.

(f) *Rules for application of section 213.* For purposes of section 213 (a) (relating to medical, dental, etc., expenses) amounts excluded from gross income under subsection (c) or (d) shall not be considered as compensation (by insurance or otherwise) for expenses paid for medical care.

§ 1.105–1 Amounts attributable to employer contributions.

(a) *In general.* Under section 105 (a), amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in his gross income to the extent that such amounts (1) are attributable to the contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer, unless such

amounts are excluded therefrom under section 105 (b), (c), or (d). For purposes of this section, the term "amounts received by an employee through an accident or health plan" refers to any amounts received through accident or health insurance, and also to any amounts which, under section 105 (e), are treated as being so received. See § 1.105–5. In determining the extent to which amounts received for personal injuries or sickness by an employee through an accident or health plan are subject to the provisions of section 105 (a), rather than section 104 (a) (3), the provisions of paragraphs (b), (c), (d), and (e) of this section shall apply.

(b) *Noncontributory plans.* All amounts received by employees through an accident or health plan which is financed solely by their employer, either by payment of premiums on an accident or health insurance policy (whether on a group or individual basis), by contributions to a fund which pays accident or health benefits, or by direct payment of the benefits under the plan, are subject to the provisions of section 105 (a), except to the extent that they are excludable under section 105 (b), (c), or (d). This rule may be illustrated by the following examples:

Example (1). Employer A maintains a plan for his employees which provides that he will continue to pay regular wages to employees who are absent from work due to sickness or personal injuries. Employees make no contributions to the plan and all benefits are paid by the employer. Amounts received by employees under the plan are subject to section 105 (a), and must be included in gross income unless excluded therefrom under section 105 (b), (c), or (d).

Example (2). Pursuant to a State nonoccupational disability benefits law, employer B maintains an accident and health plan for his employees. Although under the State law B is authorized to withhold from his employees' wages a specified amount for employee contributions to the State fund, in actual practice B does not so withhold and makes all contributions out of his own funds. All amounts received by B's employees from the State fund are subject to section 105 (a), and must be included in gross income unless excluded therefrom under section 105 (b), (c), or (d).

(c) *Contributory plans.* (1) In the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, section 105 (a) applies to the extent that such amounts are attributable to contributions of the employer which were not includible in the employee's gross income. The portion of such amounts which is attributable to such contributions of the employer shall be determined in accordance with paragraph (d) of this section in the case of an insured plan, or paragraph (e) of this section in the case of a noninsured plan. As used in this section, the phrase "contributions of the employer" means employer contributions which were not includible in the gross income of the employee. See section 106 for the exclusion from an employee's gross income of employer contributions to accident or health plans.

(2) A separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in any case where the plan provides that some classes of covered employees contribute but others do not, or that the employer will make different contributions for different classes of employees, or that different classes of employees will make different contributions, and where in any such case both the contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained. For example, if employees contribute during the first year of employment but not thereafter, there will have to be a separate determination for first year employees, provided that the amount of the contributions of the employer on account of first-year employees and the contributions of such first-year employees can be ascertained for the required periods to apply the rules of paragraph (d) or (e) of this section. If in such a case the contributions of the employer to the plan on account of first-year employees are not distinguishable from his other contributions to the plan, then the determination shall be made for all employees under the plan, and such determination shall be used by all employees under the plan.

(3) Except as provided in paragraph (c) (2) of § 1.72–15, if the plan provides accident or health benefits as well as other benefits for the employees, and if the respective contributions made by the employer and the employees to provide the accident or health benefits cannot be ascertained, the determination of the portion of the accident or health benefits received under such plan which is attributable to the contributions of the employer shall be made in accordance with the rules of paragraph (d) or (e) of this section on the basis of the contributions of the employer and of the employees to the entire plan.

(4) A determination of the portion attributable to the contributions of the employer, once made in accordance with the rules of this section, shall as to such portion be used for all purposes. For example, if an employee receives amounts under a wage continuation plan during the month of January and terminates his services during February, the portion of such amounts which is attributable to the contributions of the employer may be determined in order to provide the employee with such information at the time he is provided his Form W–2. The determination made for such purpose will also be used by the employee to report his income for his taxable year in which such amounts are received, without regard to the experience under the plan for the rest of the year.

(d) *Insured plans*—(1) *Individual policies.* If an amount is received from an insurance company by an employee under an individual policy of accident or health insurance purchased by contributions of the employer and the employee, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the portion of the premiums paid by the employer for the current policy year bears to the total premiums paid by the employer and the employee for that year. This rule may be illustrated by the following example:

Example. Employer A maintains a plan whereby he pays two-thirds of the annual premium cost on individual policies of accident and health insurance for his employees. The remainder of each employee's premium is paid by a payroll deduction from the wages of the employee. The annual premium for employee X is $24, of which $16 is paid by the employer. Thus, 16/24 or two-thirds of all amounts received by X under such insurance policy are attributable to the contributions of the employer and are subject to section 105 (a), and the remaining one-third of such amounts is excludable from X's gross income under section 104 (a) (3).

(2) *Group policies.* If the accident or health coverage is provided under or is a part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received, as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year, bears to the total of the net premiums contributed by the employer and all employees for such policy years. If the net premiums for such coverage for a period of at least three policy years are not known at the beginning of the calendar year but are known for at least one policy year, such determination shall be made by using the net premiums for such coverage which are known at the beginning of the calendar year. If the net premiums for such coverage are not known at the beginning of the calendar year for even one policy year, such determination shall be made by using either (i) a reasonable estimate of the net premiums for the first policy year, or (ii) if the net premiums for a policy year are ascertained during the calendar year, by using such net premiums. These rules may be illustrated by the following example:

Example. An employer maintains a plan under which a portion of the cost of a group policy of accident and health insurance for his employees is paid through payroll deductions from wages of the employees. The remainder of the cost is borne by the employer. The policy year begins on November 1 and ends on October 31. The net premium for the policy year ended October 31, 1954, is not known on January 1, 1955, because certain retroactive premium adjustments, such as dividends and credits, are not determinable until after January 1. Therefore, for purposes of this computation the last three policy years are the policy years ended October 31, 1951, 1952, and 1953. The net premium for the policy year ended October 31, 1953, was $8,000, of which the employer contributed $3,000; the net premium for the policy year ended October 31, 1952, was $9,000, of which the employer contributed $3,500; and the net premium for the policy year ended October 31, 1951, was $7,000, of which

the employer contributed $1,500. The portion of any amount received under the policy by an employee at any time during 1955 which is attributable to the contributions of the employer is to be determined by using the ratio of $8,000 ($3,000 plus $3,500 plus $1,500) to $24,000 ($8,000 plus $9,000 plus $7,000. Thus, $\frac{\$8,000}{\$24,000}$ or one-third, of the amounts received by an employee at any time during 1955 is attributable to contributions of the employer.

(e) *Noninsured plans.* If the accident or health benefits are a part of a noninsured plan to which the employer and the employees contribute, and such plan has been in effect for at least three years before the beginning of the calendar year, the portion of the amount received which is attributable to the employer's contributions shall be an amount which bears the same ratio to the amount received as the contributions of the employer for the period of three calendar years next preceding the year of receipt bear to the total contributions of the employer and all the employees for such period. If, at the beginning of the calendar year of receipt, such plan has not been in effect for three years but has been in effect for at least one year, such determination shall be based upon the contributions made during the 1-year or 2-year period during which the plan has been in effect. If such plan has not been in effect for one full year at the beginning of the calendar year of receipt, such determination may be based upon the portion of the year of receipt preceding the time when the determination is made, or such determination may be made periodically (such as monthly or quarterly) and used throughout the succeeding period. For example, if an employee terminates his services on April 15, 1955, and 1955 is the first year the plan has been in effect, such determination may be based upon the contributions of the employer and the employees during the period beginning with January 1 and ending with April 15, or during the month of March, or during the quarter consisting of January, February, and March.

§ 1.105–2 Amounts expended for medical care.

Section 105(b) provides an exclusion from gross income with respect to the amounts referred to in section 105 (a) (see § 1.105–1) which are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred for the medical care (as defined in section 213 (e)) of the taxpayer, his spouse, and his dependents (as defined in section 152). However, the exclusion does not apply to amounts which are attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. See section 213 and the regulations thereunder. Section 105 (b) applies ony to amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. Thus, section 105 (b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care. For example, if under a wage continuation plan the taxpayer is entitled to regular wages during a period of absence from work due to sickness or injury, amounts received under such plan are not excludable from his gross income under section 105 (b) even though the taxpayer may have incurred medical expenses during the period of illness. Such amounts may, however, be excludable from his gross income under section 105 (d). See § 1.105–4. If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105 (b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105 (b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care. If the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care. Similarly, payment to or on behalf of the taxpayer's spouse or dependents shall constitute indirect payment to the taxpayer.

§ 1.105–3 Payments unrelated to absence from work.

Section 105(c) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) to the extent that such amounts (a) constitute payments for the permanent loss or permanent loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and (b) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. Loss of use or disfigurement shall be considered permanent when it may reasonably be expected to continue for the life of the individual. For purposes of section 105(c), loss or loss of use of a member or function of the body includes the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears. The term "disfigurement" shall be given a reasonable interpretation in the light of all the particular facts and circumstances. Section 105 (c) does not apply if the amount of the benefits is determined by reference to the period the employee is absent from work. For example, if an employee is absent from work as a result of the loss of an arm, and under the accident and health plan established by his employer, he is to receive $125 a week so long as he is absent from work for a period not in excess of 52 weeks, section 105 (c) is not applicable to such payments. See, however, section 105 (d) and § 1.105–4. However, for purposes of section 105 (c), it is immaterial whether an amount is paid in a lump sum or in installments. Section 105 (c) does not apply to amounts which are treated as workmen's compensation under paragraph (b) of § 1.104–1, or to amounts paid by reason of the death of the employee (see section 101).

§ 1.105–4 Wage continuation plans.

(a) *In general.* (1) Subject to the limitations provided in this section, section 105 (d) provides an exclusion from gross income with respect to amounts referred to in section 105 (a) which are paid to an employee through a wage continuation plan and which constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness.

(2) (i) Section 105 (d) is applicable only if the wages or payments in lieu of wages are paid pursuant to a wage continuation plan. The term "wage continuation plan" means an accident or health plan, as defined in § 1.105–5, under which wages, or payments in lieu of wages, are paid to an employee for a period during which he is absent from work on account of a personal injury or sickness. Such term includes plans under which payments are continued as long as the employee is absent from work on account of personal injury or sickness. It includes plans under which there is a limitation on the period for which benefits will be paid, such as 13 or 26 weeks, and also plans under which benefits are continued until the employee either is able to return to work or reaches retirement age. Such term also includes a plan under which wages or payments in lieu of wages are paid to an employee who is absent from work on account of personal injury or sickness, even though the plan also provides that wages or payments in lieu of wages may be paid to an employee who is absent from work for reasons other than a personal injury or sickness.

(ii) Section 105 (d) is applicable if, and only if, the employee is absent from work and such absence is due to a personal injury or sickness. Thus, if an employer has a plan for continuing the wages of employees when they are absent from work, regardless of the cause of the absence from work, section 105 (d) is applicable to any payments made under this plan to an employee whose absence from work is in fact due to a personal injury or sickness. On the other hand, although the terms of a plan provide that benefits are to be continued only as long as the employee is absent from work on account of a personal injury or sickness, section 105 (d) does not apply to payments made to an employee for a period of absence from work where such absence is not in fact due to a personal injury or sickness.

(3) (i) Section 105(d) applies only to amounts attributable to periods during which the employee would be at work were it not for a personal injury or sickness. Thus, an employee is not absent from work if he is not expected to work because, for example, he has reached retirement age. If a plan provides that an employee, who is absent from work on account of a personal injury or sickness, will receive a disability pension as long as he is disabled, section 105(d) is applicable to any payments which such an employee receives under this plan before he reaches retirement age, but section 105(d) does not apply to the payments which such an employee receives after he reaches retirement age. See § 1.72–15

for additional rules relating to the tax treatment of disability pensions.

(ii) Similarly, an employee who incurs a personal injury or sickness during his paid vacation is not allowed to exclude under section 105 (d) any of the vacation pay which he receives, since he is not absent from work on account of the personal injury or sickness. Likewise, a teacher who becomes sick during the summer or other vacation period when he is not expected to teach, is not entitled to any exclusion under section 105 (d) for the summer or vacation period. However, if an employee who would otherwise be at work during a particular period is absent from work and his absence is in fact due to a personal injury or sickness, a payment which he receives for such period under a wage continuation plan is subject to section 105 (d).

(4) A period of absence from work shall commence the moment the employee first becomes absent from work and shall end the moment the employee first returns to work. However, the exclusion provided under section 105 (d) is applicable only to payments attributable to a period of absence from work which is due to a personal injury or sickness, and to payments attributable to a period when the employee would have been at work but for such personal injury or sickness.

(5) For the purpose of section 105 (d), whether an employee is absent from work depends upon all the circumstances. For example, an employee, who is a farm hand and who lives upon the premises of his employer, is absent from work when he is unable to work even though he remains on the premises of his employer. A member of the Armed Forces, who on a particular day has no assigned duties but to stand ready for duty, is absent from work if he is unable to answer any duty call that may be made upon him. An employee is not absent from work when he performs any services for his employer at his usual place or places of employment, whether or not the services are the usual services performed by the employee. Furthermore, the employee is not absent from work when he performs substantial services for his employer, even though they are performed at a place other than his usual place of employment. Thus, if an employee returns to his usual place or places of employment and performs any services for his employer, he has returned to work, but if he merely holds occasional short conferences concerning his work with other employees or clients while hospitalized or at home recuperating, such conferences do not constitute a return to work.

(b) *Determination of amount attributable to period of absence.* The amount which is paid to an employee as wages or payments in lieu of wages for a period of absence from work due to a personal injury or sickness shall be determined by reference to the plan under which the amount is paid, and to the contract, statute, or regulation which provides the terms of the employment. However, unless the plan, contract, statute, or regulation provides otherwise, it will be presumed that no wages or plan benefits are attributable to days (or portions of days) which are not normal working days for the particular employee. Also, section 105 (d) does not apply to amounts earned prior to or subsequent to the period of absence from work, even though received during such period. These rules may be illustrated by the following examples:

Example (1). Employee A, who receives regular wages of $70 per week, normally works five days (Monday through Friday) during each week. A is absent from work on a Friday and the succeeding Monday (two working days) on account of a personal injury, but receives his regular wages with respect to such period of absence under his employer's accident and health plan. Unless the plan of A's employer, or the contract, statute, or regulation under which A is employed, provides otherwise, it will be presumed that A is not paid with respect to nonworking days (Saturday and Sunday). Therefore, the amount received by A with respect to his period of absence from work due to injury is $28, which is two days regular wages. If the plan, or the employment contract, statute, or regulation had provided that wages were paid on a 7-day per week basis and that A must be available for call to work on Saturday and Sunday, A's daily wage would have been $10, and the amount attributable to the period of absence would have been $40 ($10 per day for four days).

Example (2). Employee B is a salesman who is paid on a commission basis. The employer purchases for B an accident and health insurance policy which provides that B shall receive $50 per week during any period (after a 7-day waiting period) that he is unable to work due to personal injuries or sickness. B incurs a personal injury and is incapacitated for two weeks. He receives $50 under the insurance policy with respect to the second week of absence. In addition, during the 2-week period of absence he receives a check for $40 from his employer as his commission on a sale which he made before becoming incapacitated. Section 105 (d) applies to the $50 received through the insurance policy, but does not apply to the $40 commission which B earned prior to the period of absence from work.

(c) *Limitation in the case of absence from work due to sickness.* (1) In the case of a period of absence from work on account of sickness, the exclusion provided by section 105 (d) does not apply to amounts attributable to the first seven calendar days of each such period, unless the employee is hospitalized on account of sickness for at least one day during the period of absence from work. This 7-day rule applies to each period of absence from work because of sickness, regardless of the frequency of such absences or the closeness in time to any prior period of absence from work because of sickness. For example, employee A becomes absent from work because of sickness on Tuesday, October 4, and returns to work on the morning of Thursday, October 13. He suffers a relapse and again becomes absent from work on the afternoon of Thursday, October 13. A's return to work on the morning of Thursday, October 13, terminates the first period of absence from work because of sickness, and a new period of absence from work because of sickness begins on the afternoon of Thursday, October 13. The 7-day limitation does not apply if the absence from work is due to personal injuries. These rules may be illustrated by the following examples:

Example (1). Employee C normally works five days (Monday through Friday) during each week. On Saturday, October 1 (a nonworking day), C becomes sick and as a result, he does not return to work until Thursday, October 13. The period of absence from work due to sickness commences on Monday, October 3, and terminates when C returns to work on Thursday, October 13. If C is not hospitalized during such period of absence from work, section 105 (d) does not apply to amounts which C receives under his employer's wage continuation plan attributable to the 7-day period commencing Monday, October 3, and ending Sunday, October 9, inclusive.

Example (2). Employee D incurs a personal injury which causes him to be absent from work two days. His regular wages are continued during this period in accordance with the wage continuation plan of his employer. Since D's absence from work was due to a personal injury, rather than sickness, the 7-day waiting period does not apply, and, subject to the other requirements of section 105 (d), D is entitled to an exclusion with respect to the amounts received under the employer's plan attributable to the 2-day period of absence.

(2) The term "personal injury", as used in this section, means an externally caused sudden hurt or damage to the body brought about by an identifiable event. The term "sickness", as used in this section, means mental illnesses and all bodily infirmities and disorders other than "personal injuries". Diseases, whether resulting from the occupation or otherwise, are not considered personal injuries, but they are treated as a sickness.

(3) For the purpose of starting the 7-day waiting period, if the period of absence due to sickness commences after the start of a working day, the amount received with respect to the portion of such day that the employee is absent from work shall be considered the amount attributable to the first calendar day of the period of absence from work due to sickness. This rule may be illustrated by the following example:

Example. Employee E normally works from 9 a. m. until 5:30 p. m. on five days (Monday through Friday) during each week. From noon on Friday, September 3, until noon on Monday, September 13, E is absent from work on account of sickness but is not hospitalized at any time during this period. Section 105 (d) does not apply to amounts received by E under his employer's wage continuation plan which are attributable to the calendar period beginning September 3 and ending September 9, inclusive. However, if the other requirements of section 105 (d) are met, E may exclude from gross income amounts attributable to the period beginning September 10 and ending at noon on September 13, inclusive.

(4) If the absence from work is due to sickness, the amount attributable to the first seven calendar days of such absence includes all amounts paid for such seven calendar days, regardless of the number of work days included in such seven calendar days. For example, if on one of such seven calendar days an employee would have worked two 8-hour shifts, the amount he is paid for the two shifts is considered to be an amount attributable to only one calendar day.

(5) An employee is considered to be hospitalized for one day only if he is admitted to and confined in a hospital as a bed patient for at least one hospital day. Entry into a hospital as an in-and-out patient does not constitute hospitalization for purposes of section 105 (d). The same applies to mere entry into the out-patient ward or the emergency ward of a hospital.

(d) *Exclusion not applicable to the extent that amounts exceed a weekly rate of $100*—(1) *In general.* Amounts received under a wage continuation plan which are not excludable from gross income as being attributable to contributions of the employee (see § 1.105–1) must be included in gross income under section 105 (d) to the extent that the weekly rate of such amounts exceeds $100. Thus, an employee, who receives $50 under his employer's wage continuation plan on account of his being absent from work for two days due to a personal injury, cannot exclude the entire $50 under section 105 (d) if the weekly rate of such benefits exceeds $100. If an employee receives payments under a wage continuation plan for less than a full pay period, the excludability of such payments shall be determined under subparagraph (2) of this paragraph. In all other cases, the weekly rate and excludability of such payments under a wage continuation plan shall be determined under subparagraph (3) of this paragraph. If, with respect to any pay period or portion thereof, the employee receives amounts under two or more wage continuation plans (whether such plans are maintained by or for the same employer or by different employers), the weekly rate and excludability of amounts received under each plan shall be determined under subparagraph (3) of this paragraph and the weekly rate for purposes of section 105 (d) shall be the sum of all such weekly rates. This rule may be illustrated by the following examples:

Example (1). An employee whose weekly salary is $120 is covered by two wage continuation plans maintained by his employer. Plan A is a contributory insured plan to which the employee contributes 60 percent of the premiums and which provides a weekly payment of $30. Plan B is a salary continuation plan completely financed by the employer. Since 60 percent of the cost of plan A is contributed by the employee, 60 percent of the weekly payment of $30 ($18) is excluded from gross income under section 104 (a) (3). The remainder of each weekly payment ($12) is the weekly rate of plan A. Since the employer pays the entire cost of plan B, the weekly rate of this plan is the total amount paid per week. In the case of an employee whose weekly wages of $120 are continued under plan B, the weekly rate for the employee for purposes of section 105 (d) is $132 ($120 from plan B, plus $12 from plan A).

Example (2). Assume in Example (1) that plan A provides a waiting period of four calendar days while plan B is effective immediately. For the first four days of absence the weekly rate for purposes of section 105 (d) is $120, and for periods after the first four days the weekly rate for purposes of section 105 (d) is $132.

(2) *Daily exclusion.* If an employee receives payments under a wage continuation plan for less than a full pay period, the extent to which such benefits are excludable under section 105 (d) shall be determined by computing the daily rate of the benefits which can be excluded under section 105 (d). Such daily rate is determined by dividing the weekly rate at which wage continuation payments are excludable ($100) by the number of work days in a normal work week. This rule may be illustrated by the following example:

Example. Employee E is covered by a wage continuation plan maintained by his employer providing that E's regular salary of $220 semimonthly will be continued in case he is absent from work on account of a personal injury or sickness. E is absent from work on account of a personal injury for three days and under the plan he received $66 as wage continuation payments. The extent to which the $66 is excludable under section 105 (d) shall be determined by dividing $100 by 5, the number of work days in a normal work week for E, resulting in a daily exclusion of $20 and a total exclusion of $60.

(3) *Determination of weekly rate at which amounts are paid under a wage continuation plan.* (i) For purposes of this subparagraph the pay period of a particular wage continuation plan shall be determined by reference to such plan. If, in the usual operation of the plan, benefits are paid for the same periods as regular wages, then the pay period of such benefits shall be the period for which a payment of wages is ordinarily made to the employee by the employer. If plan benefits are ordinarily paid for different periods than regular wages then the pay period of such benefits shall be the period for which payment of such benefits is ordinarily made.

(ii) The weekly rate shall be determined in accordance with the following rules:

(*a*) *Weekly pay period.* If benefits are paid on the basis of a weekly pay period, the weekly rate at which such benefits are paid shall be the weekly amount of such benefits.

(*b*) *Biweekly pay period.* If benefits are paid on the basis of a biweekly pay period, the weekly rate at which such benefits are paid shall be one-half of the biweekly rate.

(*c*) *Semimonthly pay period.* If benefits are paid on the basis of a semimonthly pay period, the weekly rate at which such benefits are paid shall be the semimonthly rate multiplied by 24 and divided by 52.

(*d*) *Monthly pay period.* If benefits are paid on the basis of a monthly pay period, the weekly rate at which such benefits are paid shall be the monthly rate multiplied by 12 and divided by 52.

(*e*) *Other pay periods.* If benefits are paid on the basis of a period other than a period described in (*a*) through (*d*), of this subdivision the weekly rate at which such benefits are paid shall be determined by ascertaining the annual rate at which such benefits are paid and dividing such annual rate by 52.

(*f*) *Examples.* The operation of the rules of this subdivision may be illustrated by the following examples:

Example (1). A's employer maintains a noncontributory plan which provides for the continuation of regular salary during periods of absence from work due to personal injury or sickness. A, an office employee, receives regular salary of $520 per month, and he is paid on the basis of a monthly pay period. Since benefits under the salary continuation plan are paid for the same periods as regular salary, the pay period of the plan is monthly. For purposes of section 105 (d), the weekly rate at which benefits are paid to A under the plan is $120, determined as follows:

$520 (monthly rate) × 12 ---- $6,240 (annual rate)

$6,240 / 52 ---- $120 (weekly rate)

Example (2). B, a factory employee of the same employer, is paid regular wages on the basis of a 10-day pay period. B's regular wages are $200 per pay period. If B is absent from work for 15 days, the weekly rate of the amount he receives under his employer's plan will be determined as follows:

$365 × $200 / 10 ---- $7,300 (annual rate)

$7,300 / 52 ---- $140.38 (weekly rate)

(iii) If the weekly rate for purposes of section 105 (d) (as determined in subdivision (ii) of this subparagraph) does not exceed $100, the amount received which is not attributable to the 7-day waiting period described in paragraph (c) of this section is fully excludable from gross income. If the weekly rate for purposes of section 105(d) (as determined in subdivision (ii) of this subparagraph) exceeds $100, the amount received which is not attributable to the 7-day waiting period provided in paragraph (c) of this section is only partially excludable. The excludable portion of such amount shall bear the same ratio to such amount as $100 bears to the weekly rate for purposes of section 105(d). This rule may be illustrated by the following example:

Example. The weekly rate of benefits in the case of employee A in example (1) of subdivision (ii) of this subparagraph was $120. If A does not receive amounts under any other plan, this is the weekly rate for purposes of section 105(d). Assume that A is absent from work on account of a personal injury for one full month and receives full pay of $520 for such period of absence. Since there is no waiting period requirement, the exclusion is $433.33 computed as follows:

$$\frac{\$100}{\$120} \times \$520 \text{ or } \$433.33.$$

§ 1.105–5 Accident and health plans.

Sections 104(a)(3) and 105 (b), (c), and (d) exclude from gross income certain amounts received through accident or health insurance. Section 105 (e) provides that for the purposes of sections 104 and 105 amounts received through an accident or health plan for employees, and amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance. In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or

noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

§ 1.106 Statutory provisions; contributions by employer to accident and health plans.

SEC. 106. *Contributions by employer to accident and health plans.* Gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness.

§ 1.106–1 Contributions by employer to accident and health plans.

The gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105 (e)) which provides accident or health benefits directly or through insurance to one or more of his employees. However, if such insurance policy, trust, or fund provides other benefits in addition to accident or health benefits, section 106 applies only to the portion of the employer's contribution which is allocable to accident or health benefits. See paragraph (d) of § 1.104–1 and §§ 1.105–1 through 1.105–5, inclusive, for regulations relating to exclusion from an employee's gross income of amounts received through accident or health insurance and through accident or health plans.

§ 1.107 Statutory provisions; rental value of parsonages.

SEC. 107. *Rental value of parsonages.* In the case of a minister of the gospel, gross income does not include—

(1) The rental value of a home furnished to him as part of his compensation; or

(2) The rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

§ 1.107–1 Rental value of parsonages.

(a) In the case of a minister of the gospel, gross income does not include (1) the rental value of a home, including utilities, furnished to him as a part of his compensation, or (2) the rental allowance paid to him as part of his compensation to the extent such allowance is used by him to rent or otherwise provide a home. In order to qualify for the exclusion, the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel. In general, the rules provided in paragraph (e) of § 1.1402 (c)–1 will be applicable to such determination. Examples of specific services the performance of which will be considered duties of a minister for purposes of section 107 include the performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries. Also, the service performed by a qualified minister as an employee of the United States (other than as a chaplain in the Armed Forces, whose service is considered to be that of a commissioned officer in his capacity as such, and not as a minister in the exercise of his ministry), or a State, Territory, or possession of the United States, or a political subdivision of any of the foregoing, or the District of Columbia, is in the exercise of his ministry provided the service performed includes such services as are ordinarily the duties of a minister.

(b) For purposes of section 107, the term "home" means a dwelling place (including furnishings) and the appurtenances thereto, such as a garage. The term "rental allowance" means an amount paid to a minister to rent or otherwise provide a home if such amount is designated as rental allowance pursuant to official action taken prior to January 1, 1958, by the employing church or other qualified organization, or if such amount is designated as rental allowance pursuant to official action taken in advance of such payment by the employing church or other qualified organization when paid after December 31, 1957. The designation of an amount as rental allowance may be evidenced in an employment contract, in minutes of or in a resolution by a church or other qualified organization or in its budget, or in any other appropriate instrument evidencing such official action. The designation referred to in this paragraph is a sufficient designation if it permits a payment or a part thereof to be identified as a payment of rental allowance as distinguished from salary or other remuneration.

(c) A rental allowance must be included in the minister's gross income in the taxable year in which it is received, to the extent that such allowance is not used by him during such taxable year to rent or otherwise provide a home. Circumstances under which a rental allowance will be deemed to have been used to rent or provide a home will include cases in which the allowance is expended (1) for rent of a home, (2) for purchase of a home, and (3) for expenses directly related to providing a home. Expenses for food and servants are not considered for this purpose to be directly related to providing a home. Where the minister rents, purchases, or owns a farm or other business property in addition to a home, the portion of the rental allowance expended in connection with the farm or business property shall not be excluded from his gross income.

§ 1.108(a) Statutory provisions; income from discharge of indebtedness; special rule of exclusion.

SEC. 108. *Income from discharge of indebtedness*—(a) *Special rule of exclusion.* No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) The indebtedness was incurred or assumed—

(A) By a corporation, or

(B) By an individual in connection with property used in his trade or business, and

(2) Such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

§ 1.108(a)–1 Income from discharge of indebtedness.

(a) (1) Section 108(a) provides a specific exclusion from gross income, at the taxpayer's election, of the amount of income attributable to the discharge of indebtedness, in whole or in part, within the taxable year. In order to take advantage of the exclusion, the taxpayer must file a consent to applicable regulations relating to the adjustment of basis, in accordance with § 1.108(a)–2. This section applies to indebtedness incurred or assumed either (i) by a corporation, or (ii) by an individual in connection with property used in his trade or business; and it covers any such indebtedness for which the corporate or individual taxpayer is liable or subject to which the taxpayer holds property.

(2) For purposes of section 108 (a) and this section, the determination as to whether an indebtedness is incurred or assumed by an individual in connection with property used in his trade or business depends upon the facts of each particular case. Where an indebtedness (whether secured or unsecured) is incurred or assumed by an individual and where the proceeds of such indebtedness are used to purchase, improve, or repair property used in the trade or business, section 108 (a) shall apply to the discharge of such indebtedness. However, an indebtedness of an individual will not be considered as incurred in connection with property used in his trade or business merely because it can be shown that the indebtedness was secured by property used in the trade or business.

(b) (1) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized

premium, the amount of the income attributable to such premium shall be excluded from gross income. For example: On January 1, 1955, the M Corporation (which files its return on a calendar year basis) had outstanding an issue of A bonds of the face value of $10,000, and as of that day there was $100 unamortized premium on this bond issue. On September 1, 1955, the M Corporation purchased these bonds for $9,000. The total amount to be excluded from gross income under this section is $1,100.

(2) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized discount, the amount of the deduction attributable to such discount shall be disallowed as a deduction. For example: On January 1, 1955, the N Corporation (which files its return on a calendar year basis) had outstanding an issue of B bonds of the face value of $10,000, and as of that day there was $50 unamortized discount on this bond issue. On September 1, 1955, the N Corporation purchased these bonds for $9,000. The total amount to be excluded from gross income under this section is $950.

(c) Section 108 (a) and this section are inapplicable in the case of any discharge occurring in any proceeding under section 77B of the Bankruptcy Act (48 Stat. 912, repealed June 22, 1938), under Chapter X or XI of such act (11 U. S. C., ch. 10, 11), or under Chapter XV of such act (53 Stat. 1134, expired July 31, 1940) if the proceeding under such Chapter XV was initiated by a petition filed on or before July 31, 1940, and with respect to any discharge of indebtedness to which section 108 (b) applies.

§ 1.108(a)–2 Making and filing of consent.

In order to take advantage of the exclusion from gross income provided by section 108(a), a taxpayer must file with his return for the taxable year a consent to have the basis of his property adjusted in accordance with the regulations prescribed under section 1017 which are in effect at the time of filing such return. See §§ 1.1017–1 and 1.1017–2. In special cases, however, where the taxpayer establishes to the satisfaction of the Commissioner reasonable cause for failure to file the necessary consent with his original return, he may file the consent with an amended return or claim for credit or refund; and in such cases, the consent shall be to the regulations which, at the time of filing the consent, are applicable to the taxable year for which such consent is filed. In all cases the consent shall be made by or on behalf of the taxpayer on Form 982, in duplicate, in accordance with these regulations and the instructions on the form or issued therewith.

§ 1.108(b) Statutory provisions; income from discharge of indebtedness; railroad corporations.

SEC. 108. *Income from discharge of indebtedness.* * * *

(b) *Railroad corporations.* No amount shall be included in gross income by reason of the discharge, cancellation, or modification, in whole or in part, within the taxable year, of any indebtedness of a railroad corporation, as defined in section 77 (m) of the Bankruptcy Act (11 U. S. C. 205 (m)), if such discharge, cancellation, or modification is effected pursuant to an order of a court in a receivership proceeding or in a proceeding under section 77 of the Bankruptcy Act. In such cases, the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. Subsection (a) of this section shall not apply with respect to any discharge of indebtedness to which this subsection applies. This subsection shall not apply to any discharge occurring in a taxable year beginning after December 31, 1955.

§ 1.108(b)–1 Income from discharge of indebtedness of railroad corporations.

(a) Under section 108(b), the amount of any income attributable to the discharge, cancellation, or modification, in whole or in part, within the taxable year, of any indebtedness of a railroad corporation as a result of an order of a court in a receivership proceeding, or in a railroad reorganization proceeding under section 77 of the Bankruptcy Act (11 U. S. C. 205) is excluded from the gross income of the railroad corporation. The section is applicable only in a case where income accrues to a taxpayer from the discharge, modification, or cancellation of the corporate indebtedness (whether in whole or in part) pursuant to a court order.

(b) The railroad corporations to which this section and section 108 (b) apply are those defined in section 77 (m) of the Bankruptcy Act (11 U. S. C. 205 (m)), namely, any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, a suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 percent of its operating revenues from the transportation of freight in standard steam railroad freight equipment.

(c) As used in section 108 (b) and this section, the term "indebtedness" means an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount.

(d) If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized premium, the amount of the income attributable to such premium shall be excluded from gross income. If, as of the first day of the taxable year in which a discharge of indebtedness occurs, there is unamortized discount, the amount of the deduction attributable to such discount shall be disallowed as a deduction. See paragraph (b) of § 1.108 (a)–1 for examples illustrating the application of this principle.

(e) The provisions of section 108 (b) and this section are applicable with respect to any discharge occurring in a taxable year beginning before January 1, 1956.

§ 1.109 Statutory provisions; improvements by lessee on lessor's property.

SEC. 109. *Improvements by lessee on lessor's property.* Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

§ 1.109–1 Exclusion from gross income of lessor of real property of value of improvements erected by lessee.

(a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

(b) The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1945 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1950. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1955, when the improvements had a value of $100,000. Under the provisions of section 109, the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. As to the basis of the property in the hands of the A Corporation, see § 1.1019–1.

§ 1.110 Statutory provisions; income taxes paid by lessee corporation.

SEC. 110. *Income taxes paid by lessee corporation.* If—

(1) A lease was entered into before January 1, 1954,

(2) Both lessee and lessor are corporations, and

file the consent with an amended return or claim for credit or refund; and in such order.

(3) Under the lease, the lessee is obligated to pay, or to reimburse the lessor for, any part of the tax imposed by this subtitle on the lessor with respect to the rentals derived by the lessor from the lessee,

then gross income of the lessor does not include such payment or reimbursement, and no deduction for such payment or reimbursement shall be allowed to the lessee. For purposes of the preceding sentence, a lease shall be considered to have been entered into before January 1, 1954, if it is a renewal or continuance of a lease entered into before such date and if such renewal or continuance was made in accordance with an option contained in the lease on December 31, 1953.

§ 1.110–1 Income taxes paid by lessee corporation.

(a) If a lease was entered into before January 1, 1954, if both lessee and lessor are corporations, and if, under the lease, the lessee is obligated to pay, or to reimburse the lessor for, any portion of the tax imposed by subtitle A of the Code upon the lessor with respect to the rentals derived by the lessor from such lease, such payment or reimbursement of tax shall be excluded from gross income of the lessor and no deduction therefor shall be allowed to the lessee. For purposes of this section, a renewal or continuance after December 31, 1953, of a lease entered into before January 1, 1954, shall be considered a lease entered into before January 1, 1954, if such renewal or continuance is made in accordance with an option contained in the original lease on December 31, 1953, or in accordance with an option contained (on December 31, 1953) in an instrument by which the original lease was renewed or continued. Thus, assume that a corporation lessor and a corporation lessee enter into a lease on January 1, 1947. The lease expires on December 31, 1953, but may be renewed for two years at the option of the lessee. On December 31, 1953, the lessee exercises his option, and the parties further agree, in writing, that the terms of the lease may be extended for an additional two years at the lessee's option. On December 31, 1955, the lessee exercises his option. The renewal period covering 1954 and 1955 are controlled by the provisions of section 110. Similarly, section 110 is applicable to the second two-year period to which the lease has been extended. However, section 110 would not be applicable to any further extension of the terms of the lease, since such further extension would not be made pursuant to an option existing on December 31, 1953.

(b) In the case of a lease to which the provisions of section 110 are not applicable, any amounts paid or reimbursed by the lessee corporation with respect to taxes imposed by subtitle A of the Code upon the lessor corporation for rentals derived by the lessor corporation under such lease shall be included in the gross income of the lessor corporation and shall, if otherwise allowable, be allowed as a deduction to the lessee corporation.

§ 1.111 Statutory provisions; recovery of bad debts, prior taxes, and delinquency amounts.

SEC. 111. *Recovery of bad debts, prior taxes, and delinquency amounts*—(a) *General rule.* Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) *Definitions.* For purposes of subsection (a)—

(1) *Bad debt.* The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) *Prior tax.* The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) *Delinquency amount.* The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) *Recovery exclusion.* The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) *Special rules for accumulated earnings tax and for personal holding company tax.* In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

(1) A recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) Where a bad debt, prior tax, or delinquency amount was not allowable as a deduction or credit for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then a recovery exclusion shall be allowable if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541.

§ 1.111–1 Recovery of certain items previously deducted or credited.

(a) *General.* Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term "recovery exclusion" as used in this section means an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939).

(1) *Section 111 items.* The term "section 111 items" as used in this section means bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 111 item. Bad debts, prior taxes, and delinquency amounts are defined in section 111 (b) (1), (2), and (3), respectively. An example of a delinquency amount is interest on delinquent taxes. An example of the other items not expressly referred to in section 111 but nevertheless subject to the rule of exclusion is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of "recovery".* Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery". Furthermore, the term "recovery" does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not excluded.

(3) *Treatment of debt deducted in more than one year by reason of partial worthlessness.* In the case of a bad debt deducted in part for two or more prior years, each such deduction of a part of

the debt is considered a separate section 111 item. A recovery with respect to such debt is considered first a recovery of those items (or portions thereof), resulting from such debt, for which there are recovery exclusions. If there are recovery exclusions for two or more items resulting from the same bad debt, such items are considered recovered in the order of the taxable years for which they were deducted, beginning with the latest. The recovery exclusion for any such item is determined by considering the recovery exclusion with respect to the prior year for which such item was deducted as being first used to offset all other applicable recoveries in the year in which the bad debt is recovered.

(4) *Special provisions as to worthless bonds, etc., which are treated as capital losses.* Certain bad debts arising from the worthlessness of securities and certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See sections 165 (g) and 166 (d). The amounts of the deductions allowed for any year under section 1211 on account of such losses for such year are considered to be section 111 items. Any part of such losses which, under section 1211, is a deduction for a subsequent year through the capital loss carryover (any later receipt of an amount with respect to such deducted loss is a recovery) is considered a section 111 item for the year in which such loss was sustained.

(b) *Computation of recovery exclusion*—(1) *Amount of recovery exclusion allowable for year of recovery.* For the year of any recovery, the section 111 items which were deducted or credited for one prior year are considered as a group and the recovery thereon is considered separately from recoveries of any items which were deducted or credited for other years. This recovery is excluded from gross income to the extent of the recovery exclusion with respect to this group of items as (i) determined for the original year for which such items were deducted or credited (see subparagraph (2) of this paragraph) and (ii) reduced by the excludable recoveries in intervening years on account of all section 111 items for such original year. A taxpayer claiming a recovery exclusion shall submit, at the time the exclusion is claimed, the computation of the recovery exclusion claimed for the original year for which the items were deducted or credited, and computations showing the amount recovered in intervening years on account of the section 111 items deducted or credited for the original year.

(2) *Determination of recovery exclusion for original year for which items were deducted or credited.* (i) The recovery exclusion for the taxable year for which section 111 items were deducted or credited (that is, the "original taxable year") is the portion of the aggregate amount of such deductions and credits which could be disallowed without causing an increase in any tax of the taxpayer imposed under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939). For the purpose of such recovery exclusion, consideration must be given to the effect of net operating loss carryovers and carrybacks or capital loss carryovers.

(ii) This rule shall be applied by determining the recovery exclusion as the aggregate amount of the section 111 items for the original year for which such items were deducted or credited reduced by whichever of the following amounts is the greater:

(*a*) The difference between (*1*) the taxable income for such original year and (*2*) the taxable income computed without regard to the section 111 items for such original year.

(*b*) In the case of a taxpayer subject to any income tax in lieu of normal tax or surtax or both (except the alternative tax on capital gains imposed by section 1201, which is disregarded), the difference between (*1*) the income subject to such tax for such original year and (*2*) the income subject to such tax computed without regard to the section 111 items for such original year.

(Neither the amount determined under (*1*) nor the amount under (2) of (*a*) or (*b*) of this subdivision shall in any case be considered less than zero.) For this determination of the recovery exclusion, the aggregate of the section 111 items must be further decreased by the portion thereof which caused a reduction in tax in preceding or succeeding taxable years through any net operating loss carryovers or carrybacks or capital loss carryovers affected by such items. This decrease is the aggregate of the largest amount determined for each of such preceding and succeeding years under (*a*) and (*b*) of this subdivision, the computation of each carryover or carryback to the preceding or succeeding year being made under (*1*) of (*a*) and (*b*) of this subdivision with regard to the section 111 items for the original year and such computation being made under (2) of (*a*) and (*b*) of this subdivision without regard to such items. For the purpose of the preceding sentence, the computations under both (*1*) and (2) of (*a*) and (*b*) of this subdivision shall be made without regard to any section 111 items for such preceding or succeeding year and the carryovers and carrybacks to such year shall be determined without regard to any section 111 items for years subsequent to the original year.

(iii) The determination of the recovery exclusion for original taxable years subject to the provisions of the Internal Revenue Code of 1939 shall be made under 26 CFR (1939) 39.22(b)(12)–1(b)(2) (Regulations 118).

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. A single individual with no dependents has for his 1954 taxable year the following income and deductions:

	With deduction of section 111 items	Without deduction of section 111 items
Gross income	$25,000	$25,000
Less deductions:		
Depreciation	20,000	20,000
Business bad debts and taxes	6,300	600
Personal exemption	600	
	26,900	20,600
Taxable income or (loss)	(1,900)	4,400
Adjustment under section 172 (d) (3)	600	
Net operating loss	(1,300)	

The full amount of the net operating loss of $1,300 is carried back and allowed as a deduction for 1952. The aggregate of the section 111 items for 1954 is $6,300 (bad debts and taxes). The recovery exclusion on account of section 111 items for 1954 is $600, determined by reducing the $6,300 aggregate of the section 111 items by $5,700, i. e., the sum of (1) the difference between the amount of the taxable income for 1954 computed without regard to the section 111 items ($4,400) and the amount of the taxable income for 1954 (not less than zero) computed by taking such items into account, and (2) the amount of the net operating loss ($1,300) which caused the reduction in tax for 1952 by reason of the carryback provisions. If in 1956 the taxpayer recovers $400 of the bad debts, all of the recovery is excluded from the income by reason of the recovery exclusion of $600 determined for the original year 1954. If in 1957 the taxpayer recovers an additional $800 of the bad debts, only $200 is excluded from gross income. That is, the recovery exclusion of $600 determined for the original year 1954 is reduced by the $400 recovered in 1956, leaving a balance of $200 which is used in 1957. The balance of the amount recovered in 1957, $100 ($300 less $200), is included in gross income for 1957.

(c) *Provisions as to taxes imposed by section 531 (relating to the accumulated earnings tax) and section 541 (relating to the tax on personal holding companies).* A recovery exclusion allowed for purposes of subtitle A (other than section 531 or section 541) of the Internal Revenue Code of 1954 shall also be allowed for the purpose of determining the accumulated earnings tax under section 531 or the personal holding company tax under section 541 regardless of whether or not the section 111 items on which such recovery exclusion is based resulted in a reduction of the tax under section 531 or section 541 of the Internal Revenue Code of 1954 (or corresponding provisions of prior income tax laws) for the prior taxable year. Furthermore, if there is recovery of a section 111 item which was not allowable as a deduction or credit for the prior taxable year for purposes of subtitle A (not including section 531 or section 541) or corresponding provisions of prior income tax laws (other than subchapter E, chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), but was allowable for such prior taxable year in determining the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws) then for the purpose of determining the tax under section 531 or section 541 a recovery exclusion shall be allowable with respect to such recovery if the section 111 item did not result in a reduction of the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws).

year for which the return is made.

§ 1.112 Statutory provisions; certain combat pay of members of the Armed Forces.

SEC. 112. *Certain combat pay of members of the Armed Forces*—(a) *Enlisted personnel.* Gross income does not include compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member—

(1) Served in a combat zone during an induction period, or

(2) Was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone during an induction period; but this paragraph shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subsection (c) (3) of this section.

(b) *Commissioned officers.* Gross income does not include so much of the compensation as does not exceed $200 received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which such officer—

(1) Served in a combat zone during an induction period, or

(2) Was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone during an induction period; but this paragraph shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subsection (c) (3) of this section.

(c) *Definitions.* For purposes of this section—

(1) The term "commissioned officer" does not include a commissioned warrant officer.

(2) The term "combat zone" means any area which the President of the United States by Executive Order designates, for purposes of this section or corresponding provisions of prior income tax laws, as an area in which Armed Forces of the United States are or have (after June 24, 1950) engaged in combat.

(3) Service is performed in a combat zone only if performed on or after the date designated by the President by Executive Order as the date of the commencing of combatant activities in such zone, and on or before the date designated by the President by Executive Order as the date of the termination of combatant activities in such zone; except that June 25, 1950, shall be considered the date of the commencing of combatant activities in the combat zone designated in Executive Order 10195.

(4) The term "compensation" does not include pensions and retirement pay.

(5) The term "induction period" means any period during which, under laws heretofore or hereafter enacted relating to the induction of individuals for training and service in the Armed Forces of the United States, individuals (other than individuals liable for induction by reason of a prior deferment) are liable for induction for such training and service.

§ 1.112–1 Compensation of members of the Armed Forces of the United States for service in a combat zone during an induction period, or for service while hospitalized as a result of such combat-zone service.

(a) In addition to the exemptions and credits otherwise applicable, section 112 provides that there shall be excluded from gross income:

(1) Compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member (i) served in a combat zone during an induction period, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone.

(2) In the case of compensation received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which such officer (i) served in a combat zone during an induction period, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone, so much of such compensation as does not exceed $200.

(b) The exclusions under section 112 and this section are applicable only if active service is performed in a combat zone during an induction period. Compensation is subject to exclusion whether or not it is received outside a combat zone or while the recipient is hospitalized or in a year different from that in which the service was rendered for which the compensation is paid. Service is performed in a combat zone only if it is performed in an area which the President of the United States has designated by Executive order, for the purpose of section 112, as an area in which Armed Forces of the United States are or have engaged in combat, and only if it is performed on or after the date designated by the President by Executive order as the date of the commencing of combatant activities in such zone and on or before the date designated by the President by Executive order as the date of the termination of combatant activities in such zone. Section 112 (c) (3) provides that June 25, 1950, shall be considered the date of commencing of combatant activities in the combat zone designated in Executive Order 10195 (3 CFR, 1949–1953 Comp., 373). In Executive Order 10585 (3 CFR, 1955 Supp. 51), the President designated January 31, 1955, as of midnight thereof, as the date of termination of combatant activities in the combat zone designated in Executive Order 10195. If a member of the Armed Forces serves in a combat zone for any part of a month during an induction period, he is entitled to the exclusion for such month to the same extent as if he has served in such zone, for the entire month. If a member of the Armed Forces is hospitalized for a part of a month as a result of wounds, disease, or injury incurred while serving in such zone during an induction period, he is entitled to the exclusion for the entire month provided there are some combatant activities in any combat zone during all of such month.

(c) If an individual is hospitalized for wound, disease, or injury while serving in a combat zone, the wound, disease, or injury will, unless the contrary clearly appears, be presumed to have been incurred while serving in a combat zone. In certain cases, however, a wound, disease, or injury may have been incurred while serving in a combat zone even though the individual was not hospitalized for it while so serving. And, in exceptional cases, a wound, disease, or injury will not have been incurred while serving in a combat zone even though the individual was hospitalized for it while so serving.

(d) These principles may be illustrated by the following examples (in each case service is performed in a combat zone during an induction period):

Example (1). An individual is hospitalized in a combat zone for a specific disease after having served in such zone for three weeks. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in the combat zone.

Example (2). The facts are the same as in example (1) except that the incubation period is one year. Such disease was not incurred while serving in the combat zone.

Example (3). A member of the Air Force, stationed outside the combat zone, is shot while participating in an aerial flight over the combat zone, but is not hospitalized until he returns to his home base. Such injury was incurred while serving in a combat zone.

Example (4). An individual is hospitalized for a specific disease three weeks after having departed from a combat zone. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in a combat zone.

(e) An individual is hospitalized only until such time as his status as a hospital patient ceases by reason of his discharge from the hospital.

(f) The term "induction period" means any period in which individuals are generally subject to induction into the Armed Forces of the United States under the Universal Military Training and Service Act (50 App. U. S. C. 451) or under similar acts hereafter enacted. The term does not apply to any period in which individuals are not generally subject to induction but are subject to induction by reason of a prior deferment.

(g) The term "commissioned officer" does not include a commissioned warrant officer, and, accordingly, a commissioned warrant officer is entitled to the exclusion allowed to enlisted personnel under section 112 (a). The term "compensation", for the purpose of this section, does not include pensions and retirement pay. As to who are members of the Armed Forces of the United States, see section 7701 (a) (15).

(h) These exclusions are applicable without regard to the marital status of the recipient of the compensation, and if a husband and wife both meet the requirements of the statute, then each is entitled to the benefit of an exclusion. In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community property State, any exclusion from gross income under section 112 operates before apportionment of the gross income of the spouses in accordance with community property law. For example, a man and his wife are domiciled in a community property State and he is entitled, as a commissioned officer, to the benefit of the exclusion of $200 for each month under section 112 (b). He receives $1,000 as compensation for active service for three months in a combat zone. Of such amount, $600 is excluded from gross income under section 112 (b)

and only $400 is taken into account in determining the gross income of both husband and wife.

(i) A member of the Armed Forces is in active service if he is actually serving in the Armed Forces of the United States. Periods during which a member of the Armed Forces is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service. A member of the Armed Forces in active service in a combat zone who there becomes a prisoner of war or missing in action is deemed, for the purpose of section 112 and this section, to continue in active service in the combat zone for the period for which he is entitled to such status for military pay purposes. These exclusions apply to compensation received by a member of the Armed Forces for services rendered while in active service even though payment is received subsequent to discharge or release from active service. Compensation credited to a decedent's account for a period subsequent to the established date of his death and received by his estate will be excluded under section 112 from the gross income of the estate to the same extent that it would have been excluded from the gross income of the decedent if he had lived and received such compensation.

§ 1.113 Statutory provisions; mustering-out payments for members of the Armed Forces.

SEC. 113. *Mustering-out payments for members of the Armed Forces.* Gross income does not include amounts received during the taxable year as mustering-out payments with respect to service in the Armed Forces of the United States.

§ 1.113–1 Mustering-out payments for members of the Armed Forces.

For the purposes of the exclusion from gross income under section 113 of mustering-out payments with respect to service in the Armed Forces, mustering-out payments are payments made to any recipients pursuant to the provisions of 38 U.S.C. 2105 (formerly section 5 of the Mustering-out Payment Act of 1944 and section 505 of the Veterans' Readjustment Assistance Act of 1952).

§ 1.114 Statutory provisions; sports programs conducted for the American National Red Cross.

SEC. 114. *Sports programs conducted for the American National Red Cross*—(a) *General rule.* In the case of a taxpayer which is a corporation primarily engaged in the furnishing of sports programs, gross income does not include amounts received as proceeds from a sports program conducted by the taxpayer if—

(1) The taxpayer agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) The taxpayer turns over to the American National Red Cross the proceeds from such sports program, minus the expenses paid or incurred by the taxpayer—

(A) Which would not have been so paid or incurred but for such sports program, and

(B) Which would be allowable as a deduction under section 162 (relating to trade or business expenses) but for subsection (b) of this section; and

(3) The facilities used for such program are not regularly used during the taxable year for the conduct of sports programs to which this subsection applies.

For purposes of this subsection, the term "proceeds from such sports program" includes all amounts paid for admission to the sports program, plus all proceeds received by the taxpayer from such program or activities carried on in connection therewith.

(b) *Treatment of expenses.* Expenses described in subsection (a) (2) shall be allowed as a deduction under section 162 only to the extent that such expenses exceed the amount excluded from gross income by subsection (a) of this section.

§ 1.114–1 Proceeds from certain sports programs conducted for the benefit of the American National Red Cross.

(a) *In general.* Under section 114, a corporation primarily engaged in the furnishing of sports programs may exclude from its gross income amounts received as proceeds from a sports program conducted by such corporation if each of the following requirements is met:

(1) The corporation agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) The corporation turns over to the American National Red Cross all the proceeds from such sports program, less only the expenses paid or incurred by such corporation which would not have been paid or incurred but for such sports program and which would be allowable as deductions as ordinary and necessary business expenses under section 162 (a) except for the provisions of section 114 (b); and

(3) The facilities of the corporation used in conducting such sports program are not regularly used during the taxable year for the conduct of sports programs to which section 114 (a) applies.

(b) *Certain corporations ineligible.* Section 114 does not apply in the case of a corporation organized or operated primarily to conduct or furnish, or to participate in the conduct or furnishing of, one or more sports programs for the American National Red Cross.

(c) *Proceeds from a sports program.* The proceeds from a sports program conducted for the benefit of the American National Red Cross include all amounts received by the conducting corporation, irrespective of when received, on account of such sports program, which amounts would be includible in the gross income of such conducting corporation, except for the provisions of section 114. Where the activities carried on in connection with the sports program include the sale or rental of radio, television, or movie rights, refreshments, souvenirs, parking facilities, programs, advertising, or other goods and services, whether sold or rented directly or through concessionaires, the amounts received by the conducting corporation from such sports program include all amounts received from such activities, but only where such amounts would not have been received by the conducting corporation but for the presentation of the particular sports program. Where the conducting corporation receives payments for concessions on an annual or seasonal basis, and such payments are not increased because of the particular sports program, such payments are not considered as proceeds from such sports program, and any expenses paid or incurred by the conducting corporation on account of such concession operations may not be taken into account under section 114 (a) (2) in determining the net amount of the proceeds from such sports program which the conducting corporation is required to turn over to the American National Red Cross; nor are the proceeds of a sports program considered to include amounts received by the conducting corporation which do not constitute gross income of such corporation, such as admissions taxes or the breakage on a pari-mutual wagering pool which is required to be paid over to the State.

(d) *Sports programs.* (1) Section 114 applies where the program furnished by the conducting corporation consists of sports events such as baseball, football, basketball, or racing but it does not apply to programs or events such as motion pictures, circuses, or dances which are not ordinarily considered to be competitive sporting events.

(2) A sports program includes all of the events normally making up a full program in the particular sport. A single race of a racing program consisting of more than one race would not constitute a sports program, nor would one baseball or basketball game of a doubleheader program constitute a sports program.

(e) *Treatment of expenses.* Expenses described in section 114 (a) (2) shall be allowable as deductions under section 162 only to the extent that such expenses exceed the amount excluded from gross income under section 114 (a).

§ 1.115 Statutory provisions; income of States, municipalities, etc.

SEC. 115. *Income of states, municipalities, etc.*—(a) *General rule.* Gross income does not include—

(1) Income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) Income accruing to the government of any possession of the United States, or any political subdivision thereof.

(b) *Contracts made before September 8, 1916, relating to public utilities.* Where a State or Territory, or any political subdivision thereof, or the District of Columbia, before September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which was to acquire, construct, operate, or maintain a public utility—

(1) If—

(A) By the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such public utility before any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and

(B) A part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia,

then a tax on the taxable income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this

subtitle, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under regulations prescribed by the Secretary or his delegate) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this subtitle) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the taxable income from the operation of such public utility for such taxable year.

(2) If by the terms of such contract no part of the proceeds from the operation of the public utility for the taxable year would, irrespective of the tax imposed by this subtitle, accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax on the taxable income of such person from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle.

(c) *Contracts made before May 29, 1928, relating to bridge acquisitions.* Where a State or political subdivision thereof, pursuant to a contract entered into before May 29, 1928, to which it is not a party, is to acquire a bridge—

(1) If—

(A) By the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such bridge before any division of such proceeds, and

(B) A part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of or would be applied for the benefit of such State or political subdivision,

then a tax on the taxable income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle, but there shall be refunded to such State or political subdivision (under regulations to be prescribed by the Secretary or his delegate) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this subtitle) would have accrued directly to or for the use of or would be applied for the benefit of such State or political subdivision bears to the amount of the taxable income from the operation of such bridge for such taxable year. No such refund shall be made unless the entire amount of the refund is to be applied in part payment for the acquisition of such bridge.

(2) If by the terms of such contract no part of the proceeds from the operation of the bridge for the taxable year would, irrespective of the tax imposed by this subtitle, accrue directly to or for the use of or be applied for the benefit of such State or political subdivision, then the tax on the taxable income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle.

§ 1.115–1 Bridges to be acquired by State or political subdivisions.

(a) Any State or political subdivision thereof claiming a refund under the provisions of section 115(c) of an amount equal to all or a portion of any income tax levied, assessed, collected, and paid shall file a claim therefor on Form 843 (to which there shall be attached as exhibits the matter hereinafter prescribed) with the district director for the internal revenue district in which the tax was paid, which claim shall be executed on behalf of such State or political subdivision thereof by the treasurer or other fiscal officer thereof and shall contain:

(1) A statement of the name of the taxpayer, of the amount of tax levied, assessed, collected, and paid for the taxable year or period in respect of which the claim is made, and the amount of refund thereby sought;

(2) A full statement of the facts considered by the claimant sufficient to entitle it to receive the refund, including copies of all contracts and other documents bearing on the case, and a statement that the claim is submitted under the provisions of section 115 (c);

(3) A showing which will establish to the satisfaction of the district director that the fiscal officer presenting the claim has authority to receive the amount of the refund on behalf of the State or political subdivision which he assumes to represent and to apply without delay the entire amount of such refund in part payment for the acquisition of such bridge, including copies of the laws, ordinances, or similar enactments considered by the claimant sufficient to establish its authority to receive the refund and so to apply it, together with a statement that such fiscal officer will receive and immediately so apply the entire amount of the refund; and

(4) A statement, verified by a written declaration that it is made under the penalties of perjury, made by or on behalf of the taxpayer that the taxpayer thereby joins with and concurs in the request of the State or political subdivision thereof that a refund of an amount equal to all or a portion of the tax previously paid by such taxpayer be made to such State or political subdivision, that the taxpayer agrees to receive the amount refunded from the State or political subdivision to which it is paid and immediately to apply the entire amount of such refund in part payment for the acquisition of such bridge, and that if for any reason the contract which is the basis of the claim for refund is not fully executed and performed, the taxpayer will repay to the United States upon its demand the entire amount of the refund with interest at 6 percent per annum from the date the refund is made without seeking or claiming the benefit of any statute of limitations which prior thereto may have run against the United States.

(b) No refund shall be made of any amount in excess of the amount of the tax levied, assessed, collected, and paid by the taxpayer for any taxable year or period. A separate claim shall be made in respect of each separate taxable year or period. If by the terms of the contract on which the claim is based two or more States or political subdivisions of a State or States are entitled to acquire the bridge, the claim for refund in respect of each separate taxable year or period must be made jointly by the States or political subdivisions thereof so entitled. The amount refunded under section 115 (c) and this section is not considered an overpayment, within the meaning of section 6611 relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(c) A check or voucher in payment of a claim for refund allowed under section 115 (c) will be drawn in the name of the fiscal officer or officers having authority, as established under paragraph (a) (3) of this section, to receive the same, and will contain an express provision that it is issued for the sole purpose and subject to the conditions prescribed in section 115 (c) and this section.

§ 1.116 Statutory provisions; partial exclusion of dividends received by individuals.

SEC. 116. *Partial exclusion of dividends received by individuals*—(a) *Exclusion from gross income.* Effective with respect to any taxable year ending after July 31, 1954, gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $50. If the dividends received in a taxable year exceed $50, the exclusion provided by the preceding sentence shall apply to the dividends first received in such year.

(b) *Certain dividends excluded.* Subsection (a) shall not apply to any dividend from—

(1) An insurance company subject to a tax imposed by part I or II of subchapter L (sec. 801 and following);

(2) A corporation organized under the China Trade Act, 1922 (see sec. 941); or

(3) A corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) A corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(c) *Special rules for certain distributions.* For purposes of subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

(d) *Certain nonresident aliens ineligible for exclusion.* Subsection (a) does not apply to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a).

§ 1.116–1 Partial exclusion of dividends.

(a) Section 116 excludes from gross income the first $50 of dividends from domestic corporations received by an individual at any time during a taxable year which ends after July 31, 1954, whether or not the dividend is received after July 31, 1954.

(b) In the case of a joint return of husband and wife, each spouse is entitled to the exclusion (in an amount not in excess of $50) with respect to the dividends received by such spouse. Thus, if in the calendar year 1955, a husband receives $200 of dividends and his wife $100, the amount to be included in gross income is $200 (150 of the husband's dividends and $50 of the wife's dividends). If the wife receives only $30 of dividends, the entire $30 is excludable, and there is included in gross income in the joint return only $150 consisting of the dividends received by the husband

($200 less his $50 exclusion). For further examples illustrating the application of the exclusion, see § 1.34–1.

(c) Where two or more persons hold stock as tenants in common, as joint tenants, or as tenants by the entirety, the dividends received with respect to such stock shall be considered as being received by each tenant to the extent that he is entitled under local law to a share of such dividends. Where dividends constitute community property under local law each spouse shall be considered as receiving one-half of such dividends.

(d) For restrictions and limitations with respect to the type of dividends to which the exclusion is applicable, see § 1.34–3.

(e) For taxpayers not entitled to the exclusion, see § 1.34–4.

(f) The regulations with respect to determination of when dividends are received under section 34 apply also to section 116. See paragraph (e) of § 1.34–1.

§ 1.116–2 Effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7581(a)(1)(C), the regulations prescribed in § 1.116–1 shall also apply to taxable years beginning before January 1, 1954, and ending after July 31, 1954, and to taxable years beginning after December 31, 1953, and ending after July 31, 1954, but before August 17, 1954, though such years are subject to the Internal Revenue Code of 1939.

§ 1.117 Statutory provisions; scholarships and fellowship grants.

SEC. 117. *Scholarships and fellowship grants*—(a) *General rule.* In the case of an individual, gross income does not include—

(1) Any amount received—

(A) As a scholarship at an educational institution (as defined in section 151 (e) (4)), or

(B) As a fellowship grant,

including the value of contributed services and accommodations; and

(2) Any amount received to cover expenses for—

(A) Travel,
(B) Research,
(C) Clerical help, or
(D) Equipment,

which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

(b) *Limitations*—(1) *Individuals who are candidates for degrees.* In the case of an individual who is a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

(2) *Individuals who are not candidates for degrees.* In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) *Conditions for exclusion.* The grantor of the scholarship or fellowship grant is an organization described in section 501 (c) (3) which is exempt from tax under section 501 (a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) *Extent of exclusion.* The amount of the scholarship or fellowship grant excluded under subsection (a) (1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)).

§ 1.117–1 Exclusion of amounts received as a scholarship or fellowship grant.

(a) *In general.* Any amount received by an individual as a scholarship at an educational institution or as a fellowship grant, including the value of contributed services and accommodations, shall be excluded from the gross income of the recipient, subject to the limitations set forth in section 117 (b) and § 1.117–2. The exclusion from gross income of an amount which is a scholarship or fellowship grant is controlled solely by section 117. Accordingly, to the extent that a scholarship or a fellowship grant exceeds the limitations of section 117 (b) and § 1.117–2, it is includible in the gross income of the recipient notwithstanding the provisions of section 102 relating to exclusion from gross income of gifts, or section 74 (b) relating to exclusion from gross income of certain prizes and awards. For definitions, see § 1.117–3.

(b) *Exclusion of amounts received to cover expenses.* (1) Subject to the limitations provided in subparagraph (2) of this paragraph, any amount received by an individual to cover expenses for travel (including meals and lodging while traveling and an allowance for travel of the individual's family), research, clerical help, or equipment is excludable from gross income provided that such expenses are incident to a scholarship or fellowship grant which is excludable from gross income under section 117(a)(1). If, however, only a portion of a scholarship or fellowship grant is excludable from gross income under section 117(a)(1) because of the part-time employment limitation contained in section 117(b)(1) or because of the expiration of the 36-month period described in section 117(b)(2)(B), only the amount received to cover expenses incident to such excludable portion is excludable from gross income. The requirement that these expenses be incident to the scholarship or the fellowship grant means that the expenses of travel, research, clerical help, or equipment must be incurred by the individual in order to effectuate the purpose for which the scholarship or the fellowship grant was awarded.

(2)(i) In the case of a scholarship or fellowship grant which is awarded after July 28, 1956, the exclusion provided under subparagraph (1) of this paragraph is not applicable unless the amount received by the individual is specifically designated to cover expenses for travel, research, clerical help, or equipment.

(ii) In the case of a scholarship or fellowship grant awarded before July 29, 1956, the exclusion provided under subparagraph (1) of this paragraph is not applicable unless the recipient establishes, by competent evidence, that the amount was received to cover expenses for travel, research, clerical help, or equipment, but such amount need not be specifically designated. The fact that the recipient actually incurred expenses for travel, research, clerical help, or equipment is not sufficient to establish that the amount was received to cover such expenses.

(iii) The exclusion provided under subparagraph (1) of this paragraph is applicable only to the extent that the amount received for travel, research, clerical help, or equipment is actually expended for such expenses by the recipient during the term of the scholarship or fellowship grant and within a reasonable time before and after such term.

(3) The portion of any amount received to cover the expenses described in subparagraph (1) of this paragraph which is not actually expended for such expenses within the exclusion period described in subparagraph (2) of this paragraph shall, if not returned to the grantor within this period, be included in the gross income of the recipient for the taxable year in which such exclusion period expires.

§ 1.117–2 Limitations.

(a) *Individuals who are candidates for degrees*—(1) *In general.* Under the limitations provided by section 117(b)(1) in the case of an individual who is a candidate for a degree at an educational institution, the exclusion from gross income shall not apply (except as otherwise provided in subparagraph (2) of this paragraph) to that portion of any amount received as payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. Payments for such part-time employment shall be included in the gross income of the recipient in an amount determined by reference to the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient of a scholarship or a fellowship grant. A typical example of employment under this subparagraph is the case of an individual who is required, as a condition to receiving the scholarship or the fellowship grant, to perform part-time teaching services. A requirement that the individual shall furnish periodic reports

to the grantor of the scholarship or the fellowship grant for the purpose of keeping the grantor informed as to the general progress of the individual shall not be deemed to constitute the performance of services in the nature of part-time employment.

(2) *Exception.* If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving the degree, such teaching, research, or other services on the part of the recipient of a scholarship or fellowship grant who is a candidate for such degree shall not be regarded as part-time employment within the meaning of this paragraph. Thus, if all candidates for a particular education degree are required, as part of their regular course of study or curriculum, to perform part-time practice teaching services, such services are not to be regarded as part-time employment within the meaning of this paragraph.

(b) *Individuals who are not candidates for degrees*—(1) *Conditions for exclusion.* In the case of an individual who is not a candidate for a degree at an educational institution, the exclusion from gross income of an amount received as a scholarship or a fellowship grant shall apply (to the extent provided in subparagraph (2) of this paragraph) only if the grantor of the scholarship or the fellowship grant is an organization described in section 501 (c) (3) which is exempt from tax under section 501 (a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(2) *Extent of exclusion.* (i) In the case of an individual who is not a candidate for a degree, the amount received as a scholarship or a fellowship grant which is excludable from gross income under section 117 (a) (1) shall not exceed an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during the taxable year. In determining the number of months during the period for which the recipient received amounts under a scholarship or fellowship grant, computation shall be made on the basis of whole calendar months. A whole calendar month means a period of time terminating with the day of the succeeding month numerically corresponding to the day of the month of its beginning, less one, except that if there be no corresponding day of the succeeding month the period terminates with the last day of the succeeding month. For purposes of this computation a fractional part of a calendar month consisting of a period of time including 15 days or more shall be considered to be a whole calendar month and a fractional part of a calendar month consisting of a period of time including 14 days or less shall be disregarded. For example, if an individual receives a fellowship grant on September 13 which is to expire on June 12 of the following year, the grant shall be considered to have extended for a period of 9 months. If in the preceding example the grant expired on June 27, instead of June 12, the grant shall be considered to have extended for a period of 10 months.

(ii) No exclusion shall be allowed under section 117 (a) (1) to an individual who is not a candidate for a degree after the recipient has, as an individual who is not a candidate for a degree, been entitled to an exclusion under that section for a period of 36 months. This limitation applies if the individual has received any amount which was either excluded or excludable from his gross income under section 117 (a) (1) for any prior 36 months, whether or not consecutive. For example, if the individual received a fellowship grant of $7,200 for 3 years (which he elected to receive in 36 monthly installments of $200), his exclusion period would be exhausted even though he did not in any of the 36 months make use of the maximum exclusion. Accordingly, such individual would be entitled to no further exclusion from gross income with respect to any additional grants which he may receive as an individual who is not a candidate for a degree.

(iii) If an individual who is not a candidate for a degree receives amounts from more than one scholarship or fellowship grant during the taxable year, the total amounts received in the taxable year shall be aggregated for the purpose of computing the amount which may be excludable from gross income for such taxable year. If amounts are received from more than one scholarship or fellowship grant during the same month or months within the taxable year, such month or months shall be counted only once for the purpose of determining the number of months for which the individual received such amounts under the scholarships or fellowship grants during the taxable year. For example, if an individual receives a fellowship grant from one source for the months of January to June of the taxable year and also receives a fellowship grant from another source for the months of March through December of the same taxable year, he shall be considered to have received amounts for 12 months of the taxable year. See example (4) in subparagraph (3) of this paragraph for further illustration.

(3) *Examples.* The application of this paragraph may be further illustrated by the following examples, it being assumed that in each example the grantor is a grantor who is described in section 117 (b) (2) (A) and subparagraph (1) of this paragraph:

Example (1). B, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The grant is to commence on September 1, 1955, and is to end on May 31, 1956, so that it will extend over a period of 9 months. The amount of the fellowship grant is $4,500 and B receives this amount in monthly installments of $500 on the first day of each month commencing September 1, 1955. During the taxable year 1955, B receives a total of $2,000 with respect to the 4-month period September through December, inclusive. He may exclude $1,200 from gross income in the taxable year 1955 ($300 X 4) and must include the remaining $800 in gross income for that year. For the year 1956, he will exclude $1,500 ($300 X 5) from gross income with respect to the $2,500 which he receives in that year and must include in gross income $1,000.

Example (2). Assume the same facts as in example (1) except that B receives the full amount of the grant ($4,500) on September 1, 1955. Since the amount received in the taxable year 1955 is for the full term of the fellowship grant (9 months), B may exclude $2,700 ($300 X 9) from gross income for the taxable year 1955. The remaining $1,800 must be included in gross income for that year.

Example (3). C, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The amount of the grant is $4,500 for a period commencing on September 1, 1955, and ending 24 months thereafter. C receives the full amount of the grant on September 1, 1955. C may exclude from gross income for the taxable year 1955, the full amount of the grant ($4,500) since this amount does not exceed an amount equal to $300 times the number of months (24) for which he received the amount of the grant during that taxable year.

Example (4). (i) F, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant (Grant A) for two years commencing June 1, 1955, in the amount of $4,800. He elects to receive his grant in monthly installments of $200 commencing June 1, 1955. On March 1, 1956, F is awarded another post-doctorate fellowship grant (Grant B) for two years commencing September 1, 1956, in the amount of $7,200. He elects to receive this grant in monthly installments of $300 commencing September 1, 1956.

(ii) For the calendar year 1955, F receives $1,400 from Grant A which he is entitled to exclude from gross income since it does not exceed an amount equal to $300 times the number of months (7) for which he received amounts under the grant in the taxable year.

(iii) For the calendar year 1956, F receives $3,600 as the aggregate of amounts received under fellowship grants ($2,400 from Grant A and $1,200 from Grant B). F will be entitled to exclude the entire amount of $3,600 from gross income for the calendar year 1956 since such amount does not exceed an amount equal to $300 times the number of months (12) for which he received amounts under the grants in the taxable year.

(iv) For the calendar year 1957, F receives $4,600 as the aggregate of amounts received under fellowship grants ($1,000 from Grant A and $3,600 from Grant B). F will be entitled to exclude $3,600 ($300 × 12) from gross income for the calendar year 1957 and he will have to include $1,000 in gross income.

(v) For the calendar year 1958, F receives $2,400 from Grant B. F is entitled to exclude $1,500 ($300 × 5) from gross income for the calendar year 1958 and he will have to include $900 in gross income. While F receives amounts under fellowship Grant B for 8 months during the calendar year 1958, he is limited to an amount equal to $300 times 5 (months) because of the fact that he has already been entitled to exclude (and has in fact excluded) amounts received as a fellowship grant for a period of 31 months. Accordingly, he can only exclude amounts received under the fellowship grant for 5 months during the calendar year 1958, because of the 36-month limitation period. The fact that he was entitled to exclude only $1,400 ($200 a month for 7 months) instead of the maximum amount of $2,100 ($300 × 7) in 1955, is immaterial and the limitation period of 36 months is applicable.

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(vi) The following chart illustrates the computation of the number of months for which F received amounts under the fellowship grants during the respective taxable years and the computation of the total amounts received under the fellowship grants during each taxable year:

Period for which received and source	Number of months	Amounts received
1955:		
June 1 to December 31	7	
Grant A		$1,400
Grant B		None
Aggregate	7	1,400
1956:		
January 1 to August 31	8	
Grant A		1,600
Grant B		None
September 1 to December 31	4	
Grant A		600
Grant B		1,200
Aggregate	12	3,600
1957:		
January 1 to May 31	5	
Grant A		1,000
Grant B		1,500
June 1 to December 31	7	
Grant A		None
Grant B		2,100
Aggregate	12	4,600
1958:		
January 1 to August 31	8	
Grant A		None
Grant B		2,400
Aggregate	8	2,400

§ 1.117–3 Definitions.

(a) *Scholarship.* A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

(b) *Educational institution.* For definition of "educational institution" section 117 adopts the definition of that term which is prescribed in section 151 (e) (4). Accordingly, for purposes of section 117 the term "educational institution" means only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. See section 151 (e) (4) and regulations thereunder.

(c) *Fellowship grant.* A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to an individual to aid him in the pursuit of study or research. The term also includes any amount received in the nature of a family allowance as a part of a fellowship grant. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in the pursuit of study or research where the grantor is motivated by family or philanthropic considerations.

(d) *Contributed services and accommodations.* The term "contributed services and accommodations" means such services and accommodations as room, board, laundry service, and similar services or accommodations which are received by an individual as a part of a scholarship or fellowship grant.

(e) *Candidate for a degree.* The term "candidate for a degree" means an individual, whether an undergraduate or a graduate, who is pursuing studies or conducting research to meet the requirements for an academic or professional degree conferred by colleges or universities. It is not essential that such study or research be pursued or conducted at an educational institution which confers such degrees if the purpose thereof is to meet the requirements for a degree of a college or university which does confer such degrees. A student who receives a scholarship for study at a secondary school or other educational institution is considered to be a "candidate for a degree."

§ 1.117–4 Items not considered as scholarships or fellowship grants.

The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:

(a) *Educational and training allowances to veterans.* Educational and training allowances to a veteran pursuant to section 400 of the Servicemen's Readjustment Act of 1944 (58 Stat. 287) or pursuant to 38 U.S.C. 1631 (formerly section 231 of the Veterans' Readjustment Assistance Act of 1952).

(b) *Allowances to members of the Armed Forces of the United States.* Tuition and subsistence allowances to members of the Armed Forces of the United States who are students at an educational institution operated by the United States or approved by the United States for their education and training, such as the United States Naval Academy and the United States Military Academy.

(c) *Amounts paid as compensation for services or primarily for the benefit of the grantor.* (1) Except as provided in paragraph (a) of § 1.117–2, any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

§ 1.118 Statutory provisions; contributions to the capital of a corporation.

SEC. 118. *Contributions to the capital of a corporation*—(a) *General rule.* In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) *Cross reference.* For basis of property acquired by a corporation through a contribution to its capital, see section 362.

§ 1.118–1 Contributions to the capital of a corporation.

In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

§ 1.119 Statutory provisions; meals or lodging furnished for the convenience of the employer.

SEC. 119. *Meals or lodging furnished for the convenience of the employer.* There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—

(1) In the case of meals, the meals are furnished on the business premises of the employer, or

(2) In the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

§ 1.119–1 Meals and lodging furnished for the convenience of the employer.

(a) *Meals.* (1) The value of meals furnished to an employee by his employer shall be excluded from the employee's gross income if two tests are met: (i) The meals are furnished on the business premises of the employer, and (ii) the meals are furnished for the convenience of the employer. The exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation.

(2) The question of whether meals are furnished for the convenience of the employer is one of fact to be determined by analysis of all the facts and circumstances in each case. Ordinarily, meals furnished to the employee during the working day will be deemed furnished for the convenience of the employer. Likewise, meals furnished immediately preceding or immediately following working hours of the employee will be deemed to be for the convenience of the employer if the furnishing of such meals serves a business purpose of the employer other than providing additional or indirect compensation to the employee. Meals furnished on nonworking days, or at times when the employee's presence on the employer's business premises does not serve a business purpose of the employer, do not qualify for the exclusion. If the employee is required to occupy living quarters on the business premises of his employer as a condition of his employment (as defined in paragraph (b) of this section), the exclusion applies to the value of any meals furnished to the employee on such premises. There is no requirement that the employee accept such meals as a condition of employment to qualify for the exclusion.

(b) *Lodging.* The value of lodging furnished to an employee by his employer shall be excluded from the employee's gross income if three tests are met: (1) The lodging is furnished on the business premises of the employer, (2) the lodging is furnished for the convenience of the employer, and (3) the employee is required to accept such lodging as a condition of his employment. The phrase "required as a condition of his employment" means required in order for the employee to perform properly the duties of his employment. The exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such lodging is furnished as compensation.

(c) *Rules.* (1) For purposes of this section, the term "business premises of the employer" generally means the place of employment of the employee. For example, meals and lodging furnished in the employer's home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on leased land would be regarded as furnished on the business premises of the employer.

(2) The exclusion provided by section 119 applies only to meals and lodging furnished in kind, without charge or cost to the employee. If the employee has an option to receive additional compensation in lieu of meals or lodging in kind, or is required to reimburse the employer for meals or lodging furnished in kind, the value of such meals and lodging is not excluded from gross income. However, the mere fact that an employee, at his option, may decline to accept meals and lodging tendered in kind will not of itself require inclusion of the value thereof in gross income. Cash allowances for meals or lodging received by an employee are includible in gross income to the extent that such allowances constitute compensation.

(d) *Examples.* The provisions of section 119 may be illustrated by the following examples:

Example (1). A waitress who works from 7 a. m. to 4 p. m. is furnished without charge two meals a workday. In order to insure that the waitress will commence work on time, the employer encourages her to have her breakfast on his business premises before starting work, although she is not required to have her breakfast there. She is required to have her lunch on such premises. The waitress is permitted to exclude the value of these meals from her gross income under paragraph (a) of this section.

Example (2). The waitress in example (1) is allowed to have meals on the employer's premises without charge on her days off. The waitress is not permitted to exclude the value of such meals from her gross income.

Example (3). A Civil Service employee of a State is employed at an institution and is required by his employer to be available for duty at any time. Accordingly, the employer furnishes the employee with meals and lodging at the institution. Under the applicable State statute, his meals and lodging are regarded as part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from his gross income.

Example (4). An employee of an institution is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving a cash allowance in addition to his regular salary. If he elects to reside at the institution the value to the employee of the lodging furnished by the employer will be includible in the employee's gross income because his residence at the institution is not required in order for him to perform properly the duties of his employment.

§ 1.120 Statutory provisions; statutory subsistence allowance received by police.

SEC. 120. *Statutory subsistence allowance received by police*—(a) *General rule.* Gross income does not include any amount received as a statutory subsistence allowance by an individual who is employed as a police official by a State, a Territory, or a possession of the United States, by any political subdivision of any of the foregoing, or by the District of Columbia.

(b) *Limitations.* (1) Amounts to which subsection (a) applies shall not exceed $5 per day.

(2) If any individual receives a subsistence allowance to which subsection (a) applies, no deduction shall be allowed under any other provision of this chapter for expenses in respect of which he has received such allowance, except to the extent that such expenses exceed the amount excludable under subsection (a) and the excess is otherwise allowable as a deduction under this chapter.

[Section 120 repealed by sec. 3, Technical Amendments Act 1958 (72 Stat. 1607)]

§ 1.120–1 Statutory subsistence allowance received by police.

(a) Section 120 excludes from the gross income of an individual employed as a police official by a State, Territory, or possession of the United States, by any of their political subdivisions, or by the District of Columbia, any amount received as a statutory subsistence allowance to the extent that such allowance does not exceed $5 per day. For purposes of this section, the term "statutory subsistence allowance" means an amount which is designated as a subsistence allowance under the laws of a State, a Territory, or a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia and which is paid to an individual who is employed as a police official of such governmental unit. A subsistence allowance paid to a police official by any of the foregoing governmental units which is not so provided by statute may not be excluded from gross income under the provisions of section 120. The term "police official" includes an employee of any of the foregoing governmental units who has police duties, such as a sheriff, a detective, a policeman, or a State police trooper, however designated.

(b) The exclusion provided by section 120 is to be computed on a daily basis, that is, for each day for which the statutory allowance is paid. If the statute providing the allowance does not specify the daily amount of such allowance, the allowance shall be converted to a daily basis for the purpose of applying the limitation provided herein. For example, if a State statute provides for a weekly subsistence allowance, the daily amount is to be determined by dividing the weekly amount by the number of days for which the allowance is paid. Thus, if a State trooper receives a weekly statutory subsistence allowance of $40 for 5 days of the week, the daily amount would be $8, that is, $40 divided by 5. However, for purposes of this section, only $5 per day may be excluded, or $25 on a weekly basis.

(c) Expenses in respect of which the allowance under section 120 is paid may not be deducted under any provision of the income tax laws except to the extent that (1) such expenses exceed the amount of the exclusion, and (2) the excess is otherwise allowable as a deduction. For example, if a State statute

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provides a subsistence allowance of $3 per day and the taxpayer, a State trooper, incurs expeditures of $4.50 for meals while away from home overnight on official police duties only $3 would be excludable under this section. Expenses relating to such exclusion ($3) may not be deducted under any provision of the income tax laws. However, the remaining $1.50 may be an allowable deduction under section 162 as traveling expenses while away from home in the performance of official duties. See § 1.162–2.

(d) In the case of taxable years ending after September 30, 1958, section 120 and this section do not apply to amounts received as a statutory subsistence allowance for any day after September 30, 1958.

§ 1.121 Statutory provisions; cross references to other acts.

SEC. 121. *Cross references to other acts*—(a) For exemption of—

(1) Adjustments of indebtedness under wage earners' plans, see section 679 of the Bankruptcy Act (52 Stat. 938; 11 U. S. C. 1079);

(2) Allowances and expenditures to meet losses sustained by persons serving the United States abroad, due to appreciation of foreign currencies, see the Acts of March 6, 1934 (48 Stat. 466; 5 U. S. C. 118c) and April 25, 1938 (52 Stat. 221; 5 U. S. C. 118c–1);

(3) Amounts credited to the Maritime Administration under section 9 (b) (6) of the Merchant Ship Sales Act of 1946, see section 9 (c) (1) of that Act (60 Stat. 48; 50 U. S. C. App. 1742);

(4) Benefits under World War Adjusted Compensation Act, see section 308 of that Act, as amended (43 Stat. 125; 44 Stat. 827, § 3; 38 U. S. C. 618);

(5) Benefits under World War Veterans' Act, 1924, see section 3 of the Act of August 12, 1935 (49 Stat. 609; 38 U. S. C. 454a);

(6) Dividends and interest derived from certain preferred stock by Reconstruction Finance Corporation, see section 304 of the Act of March 9, 1933, as amended (49 Stat. 1185; 12 U. S. C. 51d);

(7) Earnings of ship contractors deposited in special reserve funds, see section 607 (h) of the Merchant Marine Act, 1936, as amended (52 Stat. 961, § 28; 46 U. S. C. 1177);

(8) Income derived from Federal Reserve banks, including capital stock and surplus, see section 7 of the Federal Reserve Act (38 Stat. 258; 12 U. S. C. 531);

(9) Income derived from Ogdensburg bridge across Saint Lawrence River, see section 4 of the Act of June 14, 1933, as amended (54 Stat. 259, § 2);

(10) Income derived from Owensboro bridge across Ohio River and nearby ferries, see section 4 of the Act of August 14, 1937 (50 Stat. 643);

(11) Income derived from Saint Clair River bridge and ferries, see section 4 of the Act of June 25, 1930, as amended (48 Stat. 140, § 1);

(12) Leave compensation payments under section 6 of Armed Forces Leave Act of 1946, see section 7 of that Act (60 Stat. 967; 37 U. S. C. 36);

(13) Mustering-out payments made to or on account of veterans under the Mustering-Out Payment Act of 1944, see section 5 (a) of that Act (58 Stat. 10; 38 U. S. C. 691e);

(14) Railroad retirement annuities and pensions, see section 12 of the Railroad Retirement Act of 1935, as amended (50 Stat. 316; 45 U. S. C. 228*l*);

(15) Railroad unemployment benefits, see section 2 (c) of the Railroad Unemployment Insurance Act, as amended (52 Stat. 1097; 58 Stat. 845, § 9; 45 U. S. C. 352);

(16) Special pensions of persons on Army and Navy medal of honor roll, see section 3 of the Act of April 27, 1916 (39 Stat. 54; 38 U. S. C. 393);

(17) Gain derived from the sale or other disposition of Treasury Bills, issued after June 17, 1930, under the Second Liberty Bond Act, as amended, see Act of June 17, 1930 (C. 512, 46 Stat. 775; 31 U. S. C. 754).

(18) Dependency and indemnity compensation paid to survivors of members of a uniformed service and certain other persons, see section 210 of the Servicemen's and Veterans' Survivor Benefits Act.

(b) For extension of military income-tax-exemption benefits to commissioned officers of Public Health Service in certain circumstances, see section 212 of the Public Health Service Act (58 Stat. 689; 42 U. S. C. 213).

(Sec. 121 (a) (18) added by sec. 501 (t) of Pub. Law 881 (84th Cong.) effective January 1, 1957)

STANDARD DEDUCTION FOR INDIVIDUALS

§ 1.141 Statutory provisions; standard deduction.

SEC. 141. *Standard deduction.* The standard deduction referred to in section 63 (b) (defining taxable income in case of individual electing standard deduction) shall be an amount equal to 10 percent of the adjusted gross income or $1,000, whichever is the lesser, except that in the case of a separate return by a married individual the standard deduction shall not exceed $500.

§ 1.141–1 Standard deduction.

(a) The taxpayer may elect to take, in addition to the deductions from gross income allowable in computing adjusted gross income and the deduction described in section 151, relating to personal exemptions, a standard deduction in lieu of all nonbusiness deductions (that is, deductions other than those described in section 62) and in lieu of certain credits allowable to the taxpayer, had he not so elected. See section 36. Such credits include: The credit provided by section 33 for taxes imposed by foreign countries and possessions of the United States; the credit provided by section 32 for tax withheld at source under section 1451 by the obligor on tax-free covenant bonds with respect to interest on such bonds; and the credit provided by section 35 with respect to interest on United States obligations and interest on obligations of instrumentalities of the United States.

(b) In the case of a joint return, there is only one adjusted gross income and only one standard deduction. For example, if a husband has an income of $15,000 and his spouse has an income of $12,000 for the taxable year for which they file a joint return, and they have no deductions allowable for the purpose of computing adjusted gross income, the adjusted gross income is $27,000, and the standard deduction is $1,000 (and not $2,000).

(c) In the case of taxpayers whose adjusted gross income is $5,000 or more, the standard deduction is $1,000 or 10 percent of adjusted gross income, whichever is the lesser, except that in the case of a separate return by a married individual the standard deduction is $500. For determination of marital status see § 1.143–1.

(d) In the case of taxpayers whose adjusted gross income is less than $5,000, the table provided in section 3 has incorporated a standard deduction of about 10 percent of the adjusted gross income upon which the tax is determined.

(e) An election to take the standard deduction may be made for a taxable year which is less than 12 months on account of the death of the taxpayer.

§ 1.142 Statutory provisions; individuals not eligible for standard deduction.

SEC. 142. *Individuals not eligible for standard deduction*—(a) *Husband and Wife.* The standard deduction shall not be allowed to a husband or wife if the tax of the other spouse is determined under section 1 on the basis of the taxable income computed without regard to the standard deduction.

(b) *Certain other taxpayers ineligible.* The standard deduction shall not be allowed in computing the taxable income of—

(1) A nonresident alien individual;

(2) A citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);

(3) An individual making a return under section 443 (a) (1) for a period of less than 12 months on account of a change in his annual accounting period; or

(4) An estate or trust, common trust fund, or partnership.

§ 1.142–1 Husband and wife.

(a) In the case of husband and wife, if the tax of one spouse is determined under section 1 or 1201 on the basis of the taxable income computed without regard to the standard deduction, the other spouse may not elect to take the standard deduction. If a joint return is filed and election made thereon to take the standard deduction, such deduction shall, subject to the limitations of section 141 and the regulations thereunder, be determined by reference to the aggregate adjusted gross income of both spouses. The filing of either a separate or joint return on Form 1040A constitutes an election to take the standard deduction and, if the adjusted gross income shown on the return is less than $5,000, an election to pay the optional tax imposed by section 3. See the regulations under section 4 for rules relating to elections to pay the optional tax imposed by section 3.

(b) If each spouse files a separate individual income tax return (Form 1040, 1040A, or 1040W), both spouses must elect to take the standard deduction or both spouses are denied the standard deduction. Thus, if one spouse files a return on Form 1040 or Form 1040W and does not elect to take the standard deduction, the other spouse may not elect to take the standard deduction and, hence, may not file a return on Form 1040A. For example, if A and his wife B have adjusted gross incomes of $6,000 and $3,500, respectively, from wages subject to withholding and A files a return on Form 1040 or Form 1040W and does not elect thereon to take the standard deduction, B may not file her return on Form 1040A, but must file on Form 1040 or Form 1040W and compute her tax without regard to the standard deduction. In such case, however, if both elect to take the standard deduction, either taxpayer may file on Form 1040, 1040A, or 1040W, but B's tax must be computed on the basis of the tax table in section 3.

(c) The restriction upon the right of a married person to elect the standard

deduction in his separate return is applicable with respect to the taxable years of the husband and wife ending in the same calendar year, except that in the event of the death of one spouse the restriction is applicable with respect to the taxable year ended with death and the taxable year of the surviving spouse in which such death occurs. The restriction applies unless the spouses are legally separated under a decree of divorce or separate maintenance. For determination of marital status, see § 1.143–1.

§ 1.142–2 Standard deduction not allowable.

The standard deduction is not allowable in the case of—

(a) A nonresident alien individual (including one who enters and leaves the United States at frequent intervals);

(b) A citizen of the United States entitled to the benefits of section 931;

(c) A taxable year of less than 12 months where such taxable year arises because of a change in accounting period under section 443 (a) (1); or

(d) An estate or trust, common trust fund, or partnership.

§ 1.143 Statutory provisions; determination of marital status.

SEC. 143. *Determination of marital status.* For purposes of this part—

(1) The determination of whether an individual is married shall be made as of the close of his taxable year; except that if his spouse dies during his taxable year such determination shall be made as of the time of such death; and

(2) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

§ 1.143–1 Determination of marital status.

The determination of whether an individual is married shall be made as of the close of his taxable year unless his spouse dies during his taxable year, in which case such determination shall be made as of the time of such death; and an individual shall be considered as married even though living apart from his spouse unless legally separated under a decree of divorce or separate maintenance. The provisions of this section may be illustrated by the following examples:

Example (1). Taxpayer A and his wife B both make their returns on a calendar year basis. In July 1954 they enter into a separation agreement and thereafter live apart, but no decree of divorce or separate maintenance is issued until March 1955. If A itemizes and claims his actual deductions on his return for the calendar year 1954, B may not elect the standard deduction on her return since B is considered as married to A (although permanently separated by agreement) on the last day of 1954.

Example (2). Taxpayer A makes his returns on the basis of a fiscal year ending June 30. His wife B makes her returns on the calendar year basis. A died in October 1954. In such case, since A and B were married as of the date of death, B may not elect the standard deduction for the calendar year 1954 if the income of A for the short taxable year ending with the date of his death is determined without regard to the standard deduction.

§ 1.144 Statutory provisions; election of standard deduction.

SEC. 144. *Election of standard deduction—*

(a) *Method and effect of election.* (1) If the adjusted gross income shown on the return is $5,000 or more, the standard deduction shall be allowed if the taxpayer so elects in his return, and the Secretary or his delegate shall by regulations prescribe the manner of signifying such election in the return. If the adjusted gross income shown on the return is $5,000 or more, but the correct adjusted gross income is less than $5,000, then an election by the taxpayer under the preceding sentence to take the standard deduction shall be considered as his election to pay the tax imposed by section 3 (relating to tax based on tax table); and his failure to make under the preceding sentence an election to take the standard deduction shall be considered his election not to pay the tax imposed by section 3.

(2) If the adjusted gross income shown on the return is less than $5,000, the standard deduction shall be allowed only if the taxpayer elects, in the manner provided in section 4, to pay the tax imposed by section 3. If the adjusted gross income shown on the return is less than $5,000, but the correct adjusted gross income is $5,000 or more, then an election by the taxpayer to pay the tax imposed by section 3 shall be considered as his election to take the standard deduction; and his failure to elect to pay the tax imposed by section 3 shall be considered his election not to take the standard deduction.

(3) If the taxpayer on making his return fails to signify, in the manner provided by paragraph (1) or (2), his election to take the standard deduction or to pay the tax imposed by section 3, as the case may be, such failure shall be considered his election not to take the standard deduction.

(b) *Change of election.* Under regulations prescribed by the Secretary or his delegate, a change of an election for any taxable year to take, or not to take, the standard deduction, or to pay, or not to pay, the tax under section 3, may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding, for purposes of section 142 (a), to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

(1) The spouse makes a change of election with respect to the standard deduction for the taxable year covered in such separate return, consistent with the change of election sought by the taxpayer, and

(2) The taxpayer and his spouse consent in writing to the assessment, within such period as may be agreed on with the Secretary or his delegate, of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This subsection shall not apply if the tax liability of the taxpayer's spouse, for the taxable year corresponding (for purposes of section 142 (a)) to the taxable year of the taxpayer, has been compromised under section 7122.

§ 1.144–1 Manner and effect of election to take the standard deduction.

The following rules are prescribed with respect to the manner of signifying an election by a taxpayer to take the standard deduction:

(a) In the case of a taxpayer whose adjusted gross income for the taxable year for which a return is required or permitted to be filed on Form 1040 or Form 1040W is $5,000 or more, the standard deduction shall be allowed to him if he elects on such return to take such deduction. Such taxpayer shall signify on his return his election to take the standard deduction by claiming thereon the deduction in the amount provided for in section 141 instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income. A taxpayer shall have signified his election to take the standard deduction if his return is filed on Form 1040A. If in any case the adjusted gross income shown on the return of the taxpayer is $5,000 or more, but the correct adjusted gross income is less than $5,000, then:

(1) If the taxpayer has elected on his return to take the standard deduction, he shall be deemed to have elected to pay the tax imposed by section 3; and

(2) If the taxpayer has not elected to take the standard deduction, he shall be deemed not to have elected to pay the tax imposed by section 3.

(b) In the case of a taxpayer whose adjusted gross income for the taxable year for which a return is required or permitted to be filed on Form 1040 or Form 1040W is less than $5,000, the standard deduction shall be allowed to him only if he elects, in accordance with the regulations under section 4, to pay the optional tax imposed by section 3. The filing of such return on Form 1040A constitutes an election by the taxpayer to pay the tax imposed by section 3. In any case, however, in which adjusted gross income shown on the return is less than $5,000, but the correct adjusted gross income is in fact $5,000 or more, then:

(1) If the taxpayer has elected to pay the tax imposed by section 3, he shall be deemed to have elected to take the standard deduction; and

(2) If the taxpayer has not elected to pay the tax imposed by section 3, he shall be deemed not to have elected to take the standard deduction.

(c) In the case of a husband and wife (whether separate or joint returns are filed), the election to take the standard deduction and the manner of signifying such election shall, to the extent not limited by section 142 and the regulations thereunder, be made in accordance with the rules provided in paragraphs (a) and (b) of this section.

§ 1.144–2 Change of election to take, or not to take, the standard deduction.

(a) A change of the election to take, or not to take, the standard deduction for any taxable year may be made before or after the time prescribed for filing the return for the taxable year. However, the period of time prescribed in section 6511 within which claim for credit or refund of tax must be made is not extended by the right to effect a change of election.

(b) If the spouse of the taxpayer filed a separate return for any taxable year that corresponds, for the purpose of section 142(a), to the taxable year of the taxpayer, a change of election may not be made by the taxpayer unless: (1) The spouse makes a change of election in such separate return with respect to the standard deduction consistent with the change of election sought by the taxpayer, and (2) the taxpayer and his

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spouse file with the district director for the district in which the taxpayer applies for the change of election a consent in writing to the assessment, within such period of time as may be agreed upon with such district director, of any deficiency of either the taxpayer or his spouse to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(c) A change of election for any taxable year shall not be permitted if the tax liability of the taxpayer for the taxable year, or of the taxpayer's spouse for the taxable year corresponding, for the purpose of section 142 (a), to the taxable year of the taxpayer, has been compromised under the provisions of section 7122.

§ 1.145 Statutory provisions; cross reference.

SEC. 145 *Cross reference.* For disallowance of certain credits against the tax in the case of individuals electing the standard deduction, see section 36.

DEDUCTIONS FOR PERSONAL EXEMPTIONS

§ 1.151 Statutory provisions; allowance of deductions for personal exemptions.

SEC. 151. *Allowance of deductions for personal exemptions*—(a) *Allowance of deductions.* In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

(b) *Taxpayer and spouse.* An exemption of $600 for the taxpayer; and an additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(c) *Additional exemption for taxpayer or spouse aged 65 or more*—(1) *For taxpayer.* An additional exemption of $600 for the taxpayer if he has attained the age of 65 before the close of his taxable year.

(2) *For spouse.* An additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse has attained the age of 65 before the close of such taxable year, and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(d) *Additional exemption for blindness of taxpayer or spouse*—(1) *For taxpayer.* An additional exemption of $600 for the taxpayer if he is blind at the close of his taxable year.

(2) *For spouse.* An additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. For purposes of this paragraph, the determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer; except that if the spouse dies during such taxable year such determination shall be made as of the time of such death.

(3) *Blindness defined.* For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(e) *Additional exemption for dependents*—(1) *In general.* An exemption of $600 for each dependent (as defined in section 152)—

(A) Whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $600, or

(B) Who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student.

(2) *Exemption denied in case of certain married dependents.* No exemption shall be allowed under this subsection for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

(3) *Child defined.* For purposes of paragraph (1) (B), the term "child" means an individual who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer.

(4) *Student and educational institution defined.* For purposes of paragraph (1) (B) (ii), the term "student" means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins—

(A) Is a full-time student at an educational institution; or

(B) Is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State.

For purposes of this paragraph, the term "educational institution" means only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on.

§ 1.151–1 Deductions for personal exemptions.

(a) *In general.* (1) In computing taxable income, an individual is allowed a deduction for the exemptions specified in section 151. Such exemptions are: (i) The exemptions for an individual taxpayer and spouse (the so-called personal exemptions); (ii) the additional exemptions for a taxpayer attaining the age of 65 years and spouse attaining the age of 65 years (the so-called old-age exemptions); (iii) the additional exemptions for a blind taxpayer and a blind spouse; and (iv) the exemptions for dependents of the taxpayer.

(2) A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and subject to tax under section 1 or 1201 (b) is allowed as deductions the exemptions specified in section 151, even though as to the United States such individual is a nonresident alien. See section 876 and the regulations thereunder, relating to alien residents of Puerto Rico.

(b) *Exemptions for individual taxpayer and spouse (so-called personal exemptions).* Section 151 (b) allows an exemption of $600 for the taxpayer and an additional exemption of $600 for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. Thus, a husband is not entitled to an exemption for his wife on his separate return for the taxable year beginning in a calendar year during which she has any gross income (though insufficient to require her to file a return). Since, in the case of a joint return, there are two taxpayers (although under section 6013 there is only one income for the two taxpayers on such return, i. e., their aggregate income), two exemptions of $600 are allowed on such return, one for each taxpayer spouse. If in any case a joint return is made by the taxpayer and his spouse, no other person is allowed an exemption for such spouse even though such other person would have been entitled to claim an exemption for such spouse as a dependent if such joint return had not been made.

(c) *Exemptions for taxpayer attaining the age of 65 and spouse attaining the age of 65 (so-called old-age exemptions).* (1) Section 151 (c) provides an additional exemption of $600 for the taxpayer if he has attained the age of 65 before the close of his taxable year. An additional exemption of $600 is also allowed to the taxpayer for his spouse if a separate return is made by the taxpayer and if the spouse has attained the age of 65 before the close of the taxable year of the taxpayer and, for the calendar year in which the taxable year of the taxpayer begins, the spouse has no gross income and is not the dependent of another taxpayer. If a husband and wife make a joint return, an old-age exemption of $600 will be allowed as to each taxpayer spouse who has attained the age of 65 before the close of the taxable year for which the joint return is made. The exemptions under section 151 (c) are in addition to the exemptions for the taxpayer and spouse under section 151 (b).

(2) In determining the age of an individual for the purposes of the exemption for old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, in the event of a separate return by a husband, no additional exemption for old age may be claimed for his spouse unless such spouse has attained the age of 65 on or before the close of the taxable year of the husband. In no event shall the additional exemption for old age be allowed with respect to a spouse who dies before attaining the age of 65 even though such spouse would have attained the age of 65 before the close of the taxable year of the taxpayer. For the purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.

(d) *Exemptions for the blind.* (1) Section 151 (d) provides an additional exemption of $600 for the taxpayer if he is blind at the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. The determination of whether the spouse is blind shall be made as of

the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death.

(2) The exemptions for the blind are in addition to the exemptions for the taxpayer and spouse under section 151 (b) and are also in addition to the exemptions under section 151 (c) for taxpayers and spouses attaining the age of 65 years. Thus, a single individual who has attained the age of 65 before the close of his taxable year and who is blind at the close of his taxable year is entitled, in addition to the so-called personal exemption of $600, to two further exemptions, each of $600, one by reason of his age and the other by reason of his blindness. If a husband and wife make a joint return, an exemption of $600 for the blind will be allowed as to each taxpayer spouse who is blind at the close of the taxable year for which the joint return is made.

(3) A taxpayer claiming an exemption allowed by section 151 (d) for a blind taxpayer and a blind spouse shall, if the individual for whom the exemption is claimed is not totally blind as of the last day of the taxable year of the taxpayer (or, in the case of a spouse who dies during such taxable year, as of the time of such death), attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the applicable status determination date in the opinion of such physician or optometrist (i) the central visual acuity of the individual for whom the exemption is claimed did not exceed 20/200 in the better eye with correcting lenses or (ii) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If such individual is totally blind as of the status determination date there shall be attached to the return a statement by the person or persons making the return setting forth such fact.

§ 1.151–2 Additional exemptions for dependents.

(a) Section 151(e) allows to a taxpayer an exemption of $600 for each dependent (as defined in section 152) whose gross income (as defined in section 61) for the calendar year in which the taxable year of the taxpayer begins is less than $600, or who is a child of the taxpayer and who—

(1) Has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or

(2) Is a student, as defined in paragraph (b) of § 1.151–3.

No exemption shall be allowed under section 151 (e) for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

(b) The only exemption allowed for a dependent of the taxpayer is that provided by section 151 (e). The exemptions provided by section 151 (c) (old-age exemptions) and section 151 (d) (exemptions for the blind) are allowed only for the taxpayer or his spouse. For example, where a taxpayer provides the entire support for his father who meets all the requirements of a dependent, he is entitled to only one exemption of $600 for his father (section 151 (e)), even though his father is over the age of 65.

§ 1.151–3 Definitions.

(a) *Child.* For purposes of sections 151(e), 152, and the regulations thereunder, the term "child" means a son, stepson, daughter, stepdaughter, adopted son, or adopted daughter of the taxpayer.

(b) *Student.* For purposes of section 151 (e) and section 152 (d), and the regulations thereunder, the term "student" means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State. An example of "institutional on-farm training" is that authorized by 38 U.S.C. 1652 (formerly section 252 of the Veterans' Readjustment Assistance Act of 1952), as described in section 252 of such act. A full-time student is one who is enrolled for some part of 5 calendar months for the number of hours or courses which is considered to be full-time attendance. The 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute full-time attendance. However, full-time attendance at an educational institution may include some attendance at night in connection with a full-time course of study.

(c) *Educational institution.* For purposes of sections 151 (e) and 152, and the regulations thereunder, the term "educational institution" means a school maintaining a regular faculty and established curriculum, and having an organized body of students in attendance. It includes primary and secondary schools, colleges, universities, normal schools, technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, night schools, and so forth.

§ 1.152 Statutory provisions; dependent defined.

SEC. 152. *Dependent defined*—(a) *General definition.* For purposes of this subtitle, the term "dependent" means any of the following individuals over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer (or is treated under subsection (c) as received from the taxpayer):

(1) A son or daughter of the taxpayer, or a descendant of either,

(2) A stepson or stepdaughter of the taxpayer,

(3) A brother, sister, stepbrother, or stepsister of the taxpayer,

(4) The father or mother of the taxpayer, or an ancestor of either,

(5) A stepfather or stepmother of the taxpayer,

(6) A son or daughter of a brother or sister of the taxpayer,

(7) A brother or sister of the father or mother of the taxpayer,

(8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer,

(9) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, or

(10) An individual who—

(A) Is a descendant of a brother or sister of the father or mother of the taxpayer,

(B) For the taxable year of the taxpayer receives institutional care required by reason of a physical or mental disability, and

(C) Before receiving such institutional care, was a member of the same household as the taxpayer.

(b) *Rules relating to general definition.* For purposes of this section—

(1) The terms "brother" and "sister" include a brother or sister by the halfblood.

(2) In determining whether any of the relationships specified in subsection (a) or paragraph (1) of this subsection exists, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(3) The term "dependent" does not include any individual who is not a citizen of the United States unless such individual is a resident of the United States, of a country contiguous to the United States, of the Canal Zone, or of the Republic of Panama. The preceding sentence shall not exclude from the definition of "dependent" any child of the taxpayer—

(A) Born to him, or legally adopted by him, in the Philippine Islands before January 1, 1956, if the child is a resident of the Republic of the Philippines, and if the taxpayer was a member of the Armed Forces of the United States at the time the child was born to him or legally adopted by him, or

(B) Legally adopted by him, if, for the taxable year of the taxpayer, the child has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, and if the taxpayer is a citizen of the United States.

(4) A payment to a wife which is includible in the gross income of the wife under section 71 or 682 shall not be treated as a payment by her husband for the support of any dependent.

(5) An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law.

(c) *Multiple support agreements.* For purposes of subsection (a), over half of the support of an individual for a calendar year shall be treated as received from the taxpayer if—

(1) No one person contributed over half of such support;

(2) Over half of such support was received from persons each of whom, but for the fact that he did not contribute over half of such support, would have been entitled to claim such individual as a dependent for a taxable year beginning in such calendar year;

(3) The taxpayer contributed over 10 percent of such support; and

(4) Each person described in paragraph (2) (other than the taxpayer) who contributed over 10 percent of such support files a written declaration (in such manner and form as the Secretary or his delegate may by regulations prescribe) that he will not claim such individual as a dependent for any taxable year beginning in such calendar year.

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(d) *Special support test in case of students.* For purposes of subsection (a), in the case of any individual who is—

(1) A son, stepson, daughter, or stepdaughter of the taxpayer (within the meaning of this section), and

(2) A student (within the meaning of section 151 (e) (4)),

amounts received as scholarships for study at an educational institution (as defined in section 151 (e) (4)) shall not be taken into account in determining whether such individual received more than half of his support from the taxpayer.

[Sec. 152 as amended by sec. 2, Act of Aug. 9, 1955 (Pub. Law 333, 84th Cong., 69 Stat. 626); sec. 4, Technical Amendments Act 1958 (72 Stat. 1607)]

§ 1.152–1 General definition of a dependent.

(a) (1) For purposes of the income taxes imposed on individuals by chapter 1 of the Code, the term "dependent" means any individual described in paragraphs (1) through (10) of section 152 (a) over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer.

(2) (i) For purposes of determining whether or not an individual received, for a given calendar year, over half of his support from the taxpayer, there shall be taken into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources, including support which the individual himself supplied. The term "support" includes food, shelter, clothing, medical and dental care, education, and the like. Generally, the amount of an item of support will be the amount of expense incurred by the one furnishing such item. If the item of support furnished an individual is in the form of property or lodging, it will be necessary to measure the amount of such item of support in terms of its fair market value.

(ii) In computing the amount which is contributed for the support of an individual, there must be included any amount which is contributed by such individual for his own support, including income which is ordinarily excludable from gross income, such as benefits received under the Social Security Act (42 U.S.C. ch. 7). For example, a father receives $800 social security benefits, $400 interest, and $1,000 from his son during 1955, all of which sums represent his sole support during that year. The fact that the social security benefits of $800 are not includible in the father's gross income does not prevent such amount from entering into the computation of the total amount contributed for the father's support. Consequently, since the son's contribution of $1,000 was less than one-half of the father's support ($2,200) he may not claim his father as a dependent.

(b) Section 152(a)(9) applies to any individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who lives with the taxpayer and is a member of the taxpayer's household during the entire taxable year of the taxpayer. An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law. It is not necessary under section 152(a)(9) that the dependent be related to the taxpayer. For example, foster children and children awaiting adoption may qualify as dependents. It is necessary, however, that the taxpayer both maintain and occupy the household. The taxpayer and dependent will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. The fact that the dependent dies during the year shall not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding his death. Likewise, the period during the taxable year preceding the birth of an individual shall not prevent such individual from qualifying as a dependent under section 152(a)(9). Moreover, a child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth, and if such child would otherwise have been a member of the taxpayer's household during such period.

(c) In the case of a child of the taxpayer who is under 19 or who is a student, the taxpayer may claim the dependency exemption for such child provided he has furnished more than one-half of the support of such child for the calendar year in which the taxable year of the taxpayer begins, even though the income of the child for such calendar year may be $600 or more. In such a case, there may be two exemptions claimed for the child: One on the parent's (or stepparent's) return, and one on the child's return. In determining whether the taxpayer does in fact furnish more than one-half of the support of an individual who is a child, as defined in paragraph (a) of § 1.151–3, of the taxpayer and who is a student, as defined in paragraph (b) of § 1.151–3, a special rule regarding scholarships applies. Amounts received as scholarships, as defined in paragraph (a) of § 1.117–3, for study at an educational institution shall not be considered in determining whether the taxpayer furnishes more than one-half the support of such individual. For example, A has a child who receives a $1,000 scholarship to the X college for one year. A contributes $500, which constitutes the balance of the child's support for that year. A may claim the child as a dependent, as the $1,000 scholarship is not counted in determining the support of the child. For purposes of this paragraph, amounts received for tuition payments and allowances by a veteran under the provisions of the Servicemen's Readjustment Act of 1944 (58 Stat. 284) or the Veterans' Readjustment Assistance Act of 1952 (38 U.S.C. ch. 38) are not amounts received as scholarships. See also § 1.117–4. For definition of the terms "child," "student," and "educational institution," as used in this paragraph, see § 1.151–3.

§ 1.152–2 Rules relating to general definition of dependent.

(a) (1) Except as provided in subparagraph (2) of this paragraph, to qualify as a dependent an individual must be a citizen or resident of the United States or be a resident of the Canal Zone, the Republic of Panama, Canada, or Mexico at some time during the calendar year in which the taxable year of the taxpayer begins. A resident of the Republic of the Philippines who was born to or legally adopted by the taxpayer in the Philippine Islands before January 1, 1956, at a time when the taxpayer was a member of the Armed Forces of the United States, may also be claimed as a dependent if such resident otherwise qualifies as a dependent. For definition of "Armed Forces of the United States," see section 7701 (a) (15).

(2) (i) Effective with respect to taxable years beginning after December 31, 1957, a legally adopted child of the taxpayer who lives with the taxpayer and who is a member of the taxpayer's household during the entire taxable year of the taxpayer may be claimed as a dependent if such child otherwise qualifies as a dependent and if the taxpayer is a citizen of the United States.

(ii) Under section 152(b)(3)(B) and this subparagraph, it is necessary that the taxpayer both maintain and occupy the household. The taxpayer and his legally adopted child will be considered as occupying the household for the entire taxable year of the taxpayer notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which a child is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. The fact that a child dies during the year shall not deprive the taxpayer of the deduction if the child lived in the household for the entire part of the year preceding his death. The period during the taxable year preceding the birth of a child shall not prevent such child from qualifying as a dependent under this subparagraph. Moreover, a child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth and if such child would otherwise have been a member of the taxpayer's household during such period.

(iii) It is not necessary for the child to have been legally adopted for the en-

tire taxable year of the taxpayer, provided the child lived with the taxpayer and was a member of the taxpayer's household for the entire taxable year of the taxpayer. For example, A, a citizen of the United States who makes his income tax returns on the basis of the calendar year, is employed in Brazil by an agency of the United States Government. In October 1958 he takes into his household C, a resident of Brazil who is not a citizen of the United States, for the purpose of initiating adoption proceedings. C lives with A and is a member of his household for the remainder of 1958 and for the entire calendar year 1959. On July 1, 1959, the adoption proceedings were completed and C became the legally adopted child of A. If C otherwise qualifies as a dependent, he may be claimed as a dependent by A for 1959.

(b) A payment to a wife which is includible in her gross income under section 71 or section 682 shall not be considered a payment by her husband for the support of any dependent.

(c) A legally adopted child of an individual shall be treated as a child of such individual by blood.

(d) In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. For example, a widower may continue to claim his deceased wife's father (his father-in-law) as a dependent provided he meets the other requirements of section 151.

§ 1.152–3 Multiple support agreements.

(a) Section 152(c) provides that a taxpayer shall be treated as having contributed over half of the support of an individual for the calendar year (in cases where two or more taxpayers contributed to the support of such individual) if—

(1) No one person contributed over half of the individual's support,

(2) Each member of the group which collectively contributed more than half of the support of the individual would have been entitled to the dependency exemption but for the fact that he did not contribute more than one-half of such support,

(3) The member of the group claiming the dependency exemption contributed more than 10 percent of the individual's support, and

(4) Each other person in the group who contributed more than 10 percent of such support files a written declaration that he will not claim the dependency exemption for such individual for any taxable year beginning in such calendar year.

(b) Application of the rule contained in paragraph (a) of this section may be illustrated by the following examples:

Example (1). Brothers A, B, C, and D contributed the entire support of their mother in 1956 in the following percentages: A, 30 percent; B, 20 percent; C, 29 percent; and D, 21 percent. Any one of the brothers, except for the fact that he did not contribute more than half of her support, would have been entitled to a claim his mother as a dependent. Consequently, any one of the brothers could claim a deduction for the exemption of the mother provided a written declaration (as provided in paragraph (c) of this section) from each of the other brothers is attached to his income tax return. Even though A and D together contributed more than one-half the support of the mother, A, if he wished to claim his mother as a dependent, would be required to attach written declarations from B, C, and D to his income tax return, since each of those three contributed more than 10 percent of the support and, but for the support requirement, would have been entitled to claim the dependency exemption.

Example (2). E, an individual who resides with his son, received $1,500 during the calendar year 1956, which constituted his entire support for that year. The source of the $1,500 was as follows:

Source	Amount received	Percentage of total
Social Security	$375	25
N, an unrelated neighbor	165	11
B, a brother	210	14
D, a daughter	150	10
S, a son	600	40
Total received by E	1,500	100

B, D, and S are persons each of whom, but for the fact that he did not contribute more than half of the $1,500, could claim E as a dependent for a taxable year beginning in 1956. The three together contributed $960, or 64 percent of the $1,500, and, thus, each is a member of the group to be considered for the purpose of section 152 (c). B and S are the only members of such group who can meet all the requirements of section 152 (c) and either one could claim E as a dependent for his taxable year beginning in 1956 provided he attached to his income tax return a written declaration (as provided in paragraph (c) of this section) signed by the other, and furnished the other information required by the return with respect to all the contributions to E. Inasmuch as D did not contribute more than 10 percent of E's support, she is not entitled to claim E as a dependent for a taxable year beginning in 1956 nor is she required to file a written declaration with respect to her contributions to E. N contributed over 10 percent of the support of E in 1956 but, since he is an unrelated neighbor, he does not qualify as a member of the group for the purpose of the multiple support agreement under section 152 (c).

(c) The member of a group of contributors who claims the dependency deduction for an individual under the multiple support agreement provisions of section 152 (c) must attach to his income tax return for the year of the deduction a written declaration from each of the other persons who contributed more than 10 percent of the support of such individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the dependency exemption. The written declaration required by this paragraph may be made on Form 2120, which contains a statement of the fact of contribution and a waiver of the claim for dependency exemption. Any declaration made other than on Form 2120 shall conform to the substance of Form 2120. The taxpayer claiming the exemption should be prepared to furnish other information, when required, which will substantiate his right to claim such exemption. Such information may include a statement showing the names of all contributors (whether or not members of the group described in section 152 (c)) and the amount contributed by each to the support of the claimed dependent.

§ 1.153 Statutory provisions; determination of marital status.

SEC. 153. *Determination of marital status.* For purposes of this part—

(1) The determination of whether an individual is married shall be made as of the close of his taxable year; except that if his spouse dies during his taxable year such determination shall be made as of the time of such death; and

(2) An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

§ 1.153–1 Determination of marital status.

For the purpose of determining the right of an individual to claim an exemption for his spouse under section 151 (b), the determination of whether such individual is married shall be made as of the close of his taxable year, unless his spouse dies during such year, in which case the determination shall be made as of the time of such death. An individual legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married. The provisions of this section may be illustrated by the following examples:

Example (1). A, who files his returns on the basis of a calendar year, married B on December 31, 1956. B, who had never previously married, had no gross income for the calendar year 1956 nor was she the dependent of another taxpayer for such year. A may claim an exemption for B for 1956.

Example (2). C and his wife, D, were married in 1940. They remained married until July 1956 at which time D was granted a decree of divorce. C, who files his income tax returns on a calendar year basis, cannot claim an exemption for D on his 1956 return as C and D were not married on the last day of C's taxable year. Had D died instead of being divorced, C could have claimed an exemption for D for 1956 as their marital status would have been determined as of the date of D's death.

§ 1.154 Statutory provisions; cross references.

SEC. 154. *Cross references.* (1) For definitions of "husband" and "wife", as used in section 152 (b) (4), see section 7701 (a) (17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642 (b).

(3) For exemptions of nonresident aliens, see section 873 (d).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931 (e).

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

§ 1.161 Statutory provisions; allowance of deductions.

SEC. 161. *Allowance of deductions.* In computing taxable income under section 63 (a),

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there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).

§ 1.161–1 Allowance of deductions.

Section 161 provides for the allowance as deductions, in computing taxable income under section 63(a), of the items specified in part VI (section 161 and following), subchapter B, chapter 1 of the Code, subject to the exceptions provided in part IX (section 261 and following), of such subchapter B, relating to items not deductible. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof. See also section 7852(c), relating to the taking into account, both in computing a tax under subtitle A of the Internal Revenue Code of 1954 and a tax under chapter 1 or 2 of the Internal Revenue Code of 1939, of the same item of deduction.

§ 1.162 Statutory provisions; trade or business expenses.

SEC. 162. *Trade or business expenses*—(a) *In general.* There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) A reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) Traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) Rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

(b) *Charitable contributions and gifts excepted.* No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, or the requirements as to the time of payment, set forth in such section.

(c) *Improper payments to officials or employees of foreign countries.* No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.

(d) *Cross reference.* For special rule relating to expenses in connection with subdividing real property for sale, see section 1237.

[Sec. 162 as amended by sec. 5, Technical Amendments Act 1958 (72 Stat. 1608)]

§ 1.162–1 Business expenses.

(a) *In general.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of § 1.61–3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 1.162–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such items shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114 (a) (2) shall be allowable as deductions under section 162 (a) only to the extent that such expenses exceed the amount excluded from gross income under section 114 (a).

(b) *Cross references.* (1) For charitable contributions by individuals and corporations not deductible under section 162, see § 1.162–15.

(2) For items not deductible, see sections 261–273, inclusive, and regulations thereunder.

(3) For research and experimental expenditures, see section 174 and regulations thereunder.

(4) For soil and water conservation expenditures, see section 175 and regulations thereunder.

(5) For expenditures attributable to grant or loan by United States for encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 621 and regulations thereunder.

§ 1.162–2 Traveling expenses.

(a) Traveling expenses include travel fares, meals and lodging, and expenses incident to travel such as expenses for sample rooms, telephone and telegraph, public stenographers, etc. Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted. If the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses. For the allowance of traveling expenses as deductions in determining adjusted gross income, see section 62 (2) (B) and the regulations thereunder.

(b) (1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

(2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

(c) Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip.

(d) Expenses paid or incurred by a taxpayer in attending a convention or other meeting may constitute an ordinary and necessary business expense under section 162 depending upon the facts and circumstances of each case. No distinction will be made between self-employed persons and emloyees. The fact that an employee uses vacation or leave time or that his attendance at the convention is voluntary will not necessarily prohibit the allowance of the deduction. The allowance of deductions for such expenses will depend upon whether there is a sufficient relationship between the taxpayer's trade of business and his attendance at the convention or other meeting so that he is benefiting or advancing the interests of his trade or business by such attendance. If the

convention is for political, social or other purposes unrelated to the taxpayer's trade or business, the expenses are not deductible.

(e) Commuters' fares are not considered as business expenses and are not deductible.

(f) For rules with respect to the reporting and substantiation of traveling and other business expenses of employees for taxable years beginning after December 31, 1957, see § 1.162–17.

§ 1.162–3 Cost of materials.

Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

§ 1.162–4 Repairs.

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

§ 1.162–5 Expenses for education.

(a) Expenditures made by a taxpayer for his education are deductible if they are for education (including research activities) undertaken primarily for the purpose of:

(1) Maintaining or improving skills required by the taxpayer in his employment or other trade or business, or

(2) Meeting the express requirements of a taxpayer's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his salary, status or employment.

Whether or not education is of the type referred to in subparagraph (1) of this paragraph shall be determined upon the basis of all the facts of each case. If it is customary for other established members of the taxpayer's trade or business to undertake such education, the taxpayer will ordinarily be considered to have undertaken this education for the purposes described in subparagraph (1) of this paragraph. Expenditures for education of the type described in subparagraph (2) of this paragraph are deductible under subparagraph (2) only to the extent that they are for the minimum education required by the taxpayer's employer, or by applicable law or regulations, as a condition to the retention of the taxpayer's salary, status, or employment. Expenditures for education other than those so required may be deductible under subparagraph (1) of this paragraph if the education meets the qualifications of subparagraph (1) of this paragraph. A taxpayer is considered to have made expenditures for education to meet the express requirements of his employer only if the requirement is imposed primarily for a bona fide business purpose of the taxpayer's employer and not primarily for the taxpayer's benefit. Except as provided in the last sentence of paragraph (b) of this section, in the case of teachers, a written statement from an authorized official or school officer to the effect that the education was required as a condition to the retention of the taxpayer's salary, status, or employment will be accepted for the purpose of meeting the requirements of this paragraph.

(b) Expenditures made by a taxpayer for his education are not deductible if they are for education undertaken primarily for the purpose of obtaining a new position or substantial advancement in position, or primarily for the purpose of fulfilling the general educational aspirations or other personal purposes of the taxpayer. The fact that the education undertaken meets express requirements for the new position or substantial advancement in position will be an important factor indicating that the education is undertaken primarily for the purpose of obtaining such position or advancement, unless such education is required as a condition to the retention by the taxpayer of his present employment. In any event, if education is required of the taxpayer in order to meet the minimum requirements for qualification or establishment in his intended trade or business or specialty therein, the expense of such education is personal in nature and therefore is not deductible.

(c) In general, a taxpayer's expenditures for travel (including travel while on sabbatical leave) as a form of education shall be considered as primarily personal in nature and therefore not deductible.

(d) If a taxpayer travels away from home primarily to obtain education the expenses of which are deductible under this section, his expenditures for travel, meals, and lodging while away from home are deductible. However, if as an incident of such trip the taxpayer engages in some personal activity such as sightseeing, social visiting or entertaining, or other recreation, the portion of the expenses attributable to such personal activity constitutes nondeductible personal or living expenses and is not allowable as a deduction. If the taxpayer's travel away from home is primarily personal, the taxpayer's expenditures for travel, meals, and lodging (other than meals and lodging during the time spent in participating in deductible educational pursuits) are not deductible. Whether a particular trip is primarily personal or primarily to obtain education the expenses of which are deductible under this section depends upon all the facts and circumstances of each case. An important factor to be taken into consideration in making the determination is the relative amount of time devoted to personal activity as compared with the time devoted to educational pursuits. Expenses in the nature of commuters' fares are not deductible.

(e) The provisions of this section may be illustrated by the following examples:

Example (*1*). A is employed by an accounting firm. In order to become a certified public accountant he takes courses in accounting. Since the education was undertaken prior to the time A became qualified in his chosen profession as a certified public accountant, A's expenditures for such courses and expenses for any transportation, meals, and lodging while away from home are not deductible.

Example (*2*). B, a general practitioner of medicine, takes a course of study in order to become a specialist in pediatrics. C, a general practitioner of medicine, takes a 2-week course reviewing developments in several specialized fields, including pediatrics, for the purpose of carrying on his general practice. B's expenses are not deductible because the course of study qualified him for a specialty within his trade or business. C's expenses for his education and any transportation, meals, and lodging while away from home are deductible because they were undertaken primarily to improve skills required by him in his trade or business.

Example (*3*). D is required by his employer (or by State law) either to read a list of books or to take certain courses giving six hours academic credit every two years in order to retain his position as a teacher. D fulfills the requirement by taking the courses and thereby receives an automatic increase in salary in his present position and salary schedule. Also, as the result of taking the prescribed courses, at the end of ten years, D receives a master's degree and becomes automatically eligible for an additional salary increase. Since D's purpose in taking the courses was primarily to fulfill the educational requirement of his employer, his expenses for such education and transportation, meals, and lodging while away from home are deductible.

Example (*4*). The facts are the same as in example (3) except that, due solely to a shortage of qualified teachers, D's employer does not enforce the prescribed educational requirements in that other teachers who do not fulfill those requirements are retained in their positions. D's expenses are nevertheless deductible.

Example (*5*). E, a high school teacher of physics, in order to improve skills required by him and thus improve his effectiveness as such a teacher, takes summer school courses in nuclear physics and educational methods. E's expenses for such courses are deductible.

Example (*6*). F takes summer school courses in order to improve skills required by him in his employment as a teacher. As a result of taking such courses F receives an in-grade increase in salary in his present position pursuant to a salary schedule established by the school system for which he works. F's expenditures for such courses are deductible.

Example (*7*). G, a graduate student at a university, plans to become a university professor. In order to qualify as a regular faculty member, G must obtain a graduate degree. While taking the required graduate

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courses, G is engaged in teaching at the university. G's expenses therefor are not deductible since he has not completed the education required to become qualified as a regular faculty member at the time he takes such courses.

Example (8). H, a self-employed tax consultant, decides to take a 1-week course in taxation, which is offered in City X, 500 miles away from his home. His primary purpose in going to X is to take the course, but he also takes a side trip to City Y (50 miles from X) for one day, takes a sightseeing trip while in X, and entertains some personal friends. H's transportation expenses to City X and return to his home are deductible but his transportation expenses to City Y are not deductible. H's expenses for meals and lodging while away from home will be allocated between his educational pursuits and his personal activities. Those expenses which are entirely personal, such as sightseeing and entertaining friends, are not deductible to any extent.

Example (9). The facts are the same as in example (8) except that H's primary purpose in going to City X is to take a vacation. This purpose is indicated by several factors, one of which is the fact that he spends only one week attending the tax course and devotes five weeks entirely to personal activities. None of H's transportation expenses are deductible and his expenses for meals and lodging while away from home are not deductible to the extent attributable to personal activities. His expenses for meals and lodging allocable to the week attending the tax course are, however, deductible.

§ 1.162–6 Professional expenses.

A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid or accrued in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid or accrued for office rooms, the cost of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistance. Amounts currently paid or accrued for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted.

§ 1.162–7 Compensation for personal services.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

§ 1.162–8 Treatment of excessive compensation.

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

§ 1.162–9 Bonuses to employees.

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

§ 1.162–10 Certain employee benefits.

(a) *In general.* Amounts paid or accrued by a taxpayer on account of injuries received by employees and lump-sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162 (a) if they are ordinary and necessary expenses of the trade or business. However, except as provided in paragraph (b) of this section, such amounts shall not be deductible under section 162 (a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404 (a). In such an event, the extent to which these amounts are deductible from gross income shall be governed by the provisions of section 404 and the regulations issued thereunder.

(b) *Certain negotiated plans.* (1) Subject to the limitations set forth in subparagraphs (2) and (3) of this paragraph, contributions paid by an employer under a plan under which such contributions are held in a welfare trust for the purpose of paying (either from principal or income or both) for the benefit of employees, their families, and dependents, at least medical or hospital care, and pensions on retirement or death of employees, are deductible when paid as business expenses under section 162 (a).

(2) For the purpose of subparagraph (1) of this paragraph, the word "plan" means any plan established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States, during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which the employer claiming the deduction is engaged. The phrase "plan established prior to January 1, 1954, as a result of an agreement" is intended primarily to cover a trust established under the terms of such an agreement. It also includes a trust established under a plan of an employer, or group of employers, who, by reason

of producing the same commodity, are in competition with the employers whose facilities were seized and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. For example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established in the anthracite coal industry within a reasonable time, but before January 1, 1954, would qualify under subparagraph (1) of this paragraph.

(3) If any trust described in subparagraph (2) of this paragraph becomes qualified for exemption from tax under the provisions of section 501 (a), the deductibility of contributions by an employer to such trust on or after any date of such qualification shall no longer be governed by the provisions of section 162, even though the trust may later lose its exemption from tax under section 501 (a).

(c) *Other plans providing deferred compensation.* For rules relating to the deduction of amounts paid to or under a stock bonus, pension, annuity, or profit-sharing plan or amounts paid or accrued under any other plan deferring the receipt of compensation, see section 404 and the regulations thereunder.

§ 1.162–11 Rentals.

(a) If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder.

(b) (1) The cost to a lessee of erecting buildings or making permanent improvements on property of which he is the lessee is a capital investment, and is not deductible as a business expense. If the estimated useful life in the hands of the taxpayer of the building erected or of the improvements made, determined without regard to the terms of the lease, is longer than the remaining period of the lease, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation. If, on the other hand, the useful life of such buildings or improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, this deduction shall be computed under the provisions of section 167 (relating to depreciation). Where there is a possibility that the lease may be renewed, the matter of spreading such costs over the term of the original lease, together with the renewal period or periods, depends upon the facts in the particular case, including the presence or absence of an option of renewal and the relationship between the parties. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease, or the cost of improvements shall be spread only over the number of years the lease has to run without taking into account any right of renewal.

(2) Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A subsidiary corporation leases land from its parent at a fair rental for a 25-year period. The subsidiary erects on the land valuable factory buildings having a normal useful life of 50 years. These facts show with reasonable certainty that the lease will be renewed, even though the lease contains no option of renewal. Therefore, the cost of the buildings shall be depreciated over the estimated useful life of the buildings in accordance with section 167 and the regulations thereunder.

Example (2). A retail merchandising corporation leases land at a fair rental from an unrelated lessor for the longest period that the lessor is willing to lease the land (30 years). The lessee erects on the land a department store having a normal useful life of 40 years. These facts do not show with reasonable certainty that the lease will be renewed. Therefore, the cost of the building shall be spread over the remaining term of the lease. An annual deduction may be made of an amount equal to the cost of the building divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation.

§ 1.162–12 Expenses of farmers.

A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. If a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year. The preceding sentence does not apply to the cost of seeds and young plants connected with the planting of timber. See section 611 and the regulations thereunder. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. For the treatment of soil and water conservation expenditures as expenses which are not chargeable to capital account, see section 175 and the regulations thereunder. Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and may be depreciated unless such animals are included in an inventory in accordance with § 1.61–4. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of farm products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See § 1.61–4, and paragraph (b) of § 1.167 (a)–6, and sections 165 and 270 and the regulations thereunder.)

§ 1.162–13 Depositors' guaranty fund.

Banking corporations which pursuant to the laws of the State in which they are doing business are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.

§ 1.162–14 Expenditures for advertising or promotion of good will.

A corporation which has, for the purpose of computing its excess profits tax credit under subchapter E, chapter 2, or subchapter D, chapter 1 of the Internal

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Revenue Code of 1939, elected under section 733 or section 451 (applicable to the excess profits tax imposed by subchapter E of chapter 2, and subchapter D of chapter 1, respectively) to charge to capital account for taxable years in its base period expenditures for advertising or the promotion of good will which may be regarded as capital investments, may not deduct similar expenditures for the taxable year. See section 263 (b). Such a taxpayer has the burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct in the taxable year may not be regarded as capital investments under the provisions of the regulations prescribed under section 733 or section 451 of the Internal Revenue Code of 1939. See 26 CFR, 1938 ed., 35.733–2 (Regulations 112) and 26 CFR (1939) 40.451–2 (Regulations 130).

§ 1.162–15 Excepted contributions.

(a) No deduction is allowable under section 162(a) for a contribution or gift by an individual or a corporation if any part thereof is deductible under section 170. For example, if a taxpayer makes a contribution of $5,000 and only $4,000 of this amount is deductible under section 170(a) (whether because of the percentage limitation under either section 170 (b) (1) or (2), the requirement as to time of payment, or both), no deduction is allowable under section 162 (a) for the remaining $1,000.

(b) The limitations provided in section 162 (b) and this section apply only to payments which are in fact contributions or gifts to organizations described in section 170. For example, payments by a street railway company to a local hospital (which is a charitable organization within the meaning of section 170) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the company's employees are not contributions or gifts within the meaning of section 170 and may be deductible under section 162 (a) if the requirements of section 162 (a) are otherwise satisfied. Donations to organizations other than those described in section 170 which bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses. For example, a street railway company may donate a sum of money to an organization (of a class not referred to in section 170) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its cars.

(c) (1) Expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) related to any of the foregoing purposes are not deductible from gross income. For example, the cost of advertising to promote or defeat legislation or to influence the public with respect to the desirability or undesirability of proposed legislation is not deductible as a business expense, even though the legislation may directly affect the taxpayer's business. On the other hand, expenditures for institutional or "good will" advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future. For example, a deduction will ordinarily be allowed for the cost of advertising which keeps the taxpayer's name before the public in connection with encouraging contributions to such organizations as the Red Cross, the purchase of United States Savings Bonds, or participation in similar causes. In like fashion, expenditures for advertising which present views on economic, financial, social, or other subjects of a general nature but which do not involve any of the activities specified in the first sentence of this subparagraph are deductible if they otherwise meet the requirements of the regulations under section 162.

(2) Dues and other payments to an organization, such as a labor union or a trade association, which otherwise meet the requirements of the regulations under section 162, are deductible in full unless a substantial part of the organization's activities consists of one or more of those specified in the first sentence of subparagraph (1) of this paragraph. If a substantial part of the activities of the organization consists of one or more of those so specified, deduction will be allowed only for such portion of such dues and other payments as the taxpayer can clearly establish is attributable to activities other than those so specified. The determination as to whether such specified activities constitute a substantial part of an organization's activities shall be based on all the facts and circumstances. In no event shall special assessments or similar payments (including an increase in dues) made to any organization for any of such specified purposes be deductible.

(3) Expenditures for the promotion or the defeat of legislation include, but shall not be limited to, expenditures for the purpose of attempting to—

(i) Influence members of a legislative body directly or indirectly, by urging or encouraging the public to contact such members for the purpose of proposing, supporting, or opposing legislation, or

(ii) Influence the public to approve or reject a measure in a referendum, initiative, vote on a constitutional amendment, or similar procedure.

§ 1.162–16 Cross reference.

For special rules relating to expenses in connection with subdividing real property for sale, see section 1237 and the regulations thereunder.

§ 1.162–17 Reporting and substantiation of traveling and other business expenses of employees.

(a) *Introductory.* The purpose of the regulations in this section is to provide rules for the reporting of information on income tax returns by taxpayers who pay or incur ordinary and necessary business expenses in connection with the performance of services as an employee and to furnish guidance as to the type of records which will be useful in compiling such information and in its substantiation, if required. The rules prescribed in this section do not apply to expenses paid or incurred for incidentals, such as office supplies for the employer or local transportation in connection with an errand. Employees incurring such incidental expenses are not required to provide substantiation for such amounts. The term "ordinary and necessary business expenses" means only those expenses which are ordinary and necessary in the conduct of the taxpayer's business and are directly attributable to such business. The term does not include nondeductible personal, living or family expenses.

(b) *Expenses for which the employee is required to account to his employer—* (1) *Reimbursements equal to expenses.* The employee need not report on his tax return (either itemized or in total amount) expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. In such a case the taxpayer need only state in his return that the total of amounts charged directly or indirectly to his employer through credit cards or otherwise and received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee.

(2) *Reimbursements in excess of expenses.* In case the total of amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, exceeds the ordinary and necessary business expenses paid or incurred by the employee and the employee is required to and does account to his employer for such expenses, the taxpayer must include such excess in income and state on his return that he has done so.

(3) *Expenses in excess of reimbursements.* If the employee's ordinary and necessary business expenses exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee is required to and does account to his employer for such expenses, the taxpayer may make the statement in his return required by subparagraph (1) of this paragraph unless he wishes to claim a deduction for such excess. If, however, he wishes to secure a deduction for such excess, he must submit a statement showing the following information as part of his tax return:

(i) The total of any charges paid or borne by the employer and of any other

amounts received from the employer for payment of expenses whether by means of advances reimbursements or otherwise; and

(ii) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(4) To "account" to his employer as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses. For this purpose, the Commissioner in his discretion may approve reasonable business practices under which mileage, per diem in lieu of subsistence, and similar allowances providing for ordinary and necessary business expenses in accordance with a fixed scale may be regarded as equivalent to an accounting to the employer.

(c) *Expenses for which the employee is not required to account to his employer.* If the employee is not required to account to his employer for his ordinary and necessary business expenses, e. g., travel, transportation, entertainment, and similar items, or, though required, fails to account for such expenses, he must submit, as a part of his tax return, a statement showing the following information:

(1) The total of all amounts received as advances or reimbursements from his employer in connection with the ordinary and necessary business expenses of the employee, including amounts charged directly or indirectly to the employer through credit cards or otherwise; and

(2) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(d) *Substantiation of items of expense.* (1) Although the Commissioner may require any taxpayer to substantiate such information concerning expense accounts as may appear to be pertinent in determining tax liability, taxpayers ordinarily will not be called upon to substantiate expense account information except those in the following categories:

(i) A taxpayer who is not required to account to his employer, or who does not account;

(ii) A taxpayer whose expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess;

(iii) A taxpayer who is related to his employer within the meaning of section 267 (b); and

(iv) Other taxpayers in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by employees are not adequate.

(2) The Code contemplates that taxpayers keep such records as will be sufficient to enable the Commissioner to correctly determine income tax liability. Accordingly, it is to the advantage of taxpayers who may be called upon to substantiate expense account information to maintain as adequate and detailed records of travel, transportation, entertainment, and similar business expenses as practical since the burden of proof is upon the taxpayer to show that such expenses were not only paid or incurred but also that they constitute ordinary and necessary business expenses. One method for substantiating expenses incurred by an employee in connection with his employment is through the preparation of a daily diary or record of expenditures, maintained in sufficient detail to enable him to readily identify the amount and nature of any expenditure, and the preservation of supporting documents, especially in connection with large or exceptional expenditures. Nevertheless, it is recognized that by reason of the nature of certain expenses or the circumstances under which they are incurred, it is often difficult for an employee to maintain detailed records or to preserve supporting documents for all his expenses. Detailed records of small expenditures incurred in traveling or for transportation, as for example, tips, will not be required.

(3) Where records are incomplete or documentary proof is unavailable, it may be possible to establish the amount of the expenditures by approximations based upon reliable secondary sources of information and collateral evidence. For example, in connection with an item of traveling expense a taxpayer might establish that he was in a travel status a certain number of days but that it was impracticable for him to establish the details of all his various items of travel expense. In such a case rail fares or plane fares can usually be ascertained with exactness and automobile costs approximated on the basis of mileage covered. A reasonable approximation of meals and lodging might be based upon receipted hotel bills or upon average daily rates for such accommodations and meals prevailing in the particular community for comparable accommodations. Since detailed records of incidental items are not required, deductions for these items may be based upon a reasonable approximation. In cases where a taxpayer is called upon to substantiate expense account information, the burden is on the taxpayer to establish that the amounts claimed as a deduction are reasonably accurate and constitute ordinary and necessary business expenses paid or incurred by him in connection with his trade or business. In connection with the determination of factual matters of this type, due consideration will be given to the reasonableness of the stated expenditures for the claimed purposes in relation to the taxpayer's circumstances (such as his income and the nature of his occupation), to the reliability and accuracy of records in connection with other items more readily lending themselves to detailed record-keeping, and to all of the facts and circumstances in the particular case.

(e) *Prior regulations.* The provisions of the regulations in this section are supplemental to existing regulations relating to information required to be submitted with income tax returns, and shall be applicable with respect to taxable years beginning after December 31, 1957, notwithstanding any existing regulation to the contrary.

§ 1.162–18 Improper payments to officials or employees of foreign countries.

(a) *In general.* No deduction shall be allowed under section 162(a) for any expenses paid or incurred after September 2, 1958—

(1) If the payment of the expenses is made, whether directly or indirectly, to an official or employee of a foreign country, and

(2) If the making of the payment would be unlawful under the laws of the United States (if such laws were applicable to the payment and to the official or employee at the time the expenses were paid or incurred). Lawfulness or unlawfulness of the payment under the laws of the foreign country is immaterial. Similarly, the place where the expenses are paid or incurred is immaterial. No deduction shall be allowed for an accrued expense, if the eventual payment thereof would fall within the prohibition of this section.

(b) *Indirect payment.* For purposes of this section, an indirect payment to an individual shall include any payment which inures to his benefit or is promotional of his interests, regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient. Thus, payment made to an agent or even directly into the general treasury of the country of which the beneficiary is an official or employee may be treated as an indirect payment to the official or employee, if in fact such payment inures or will inure to his benefit or is or will be promotional of his interests.

(c) *Official or employee; foreign country.* Any individual officially connected with the government of a foreign country, in whatever capacity, whether on a permanent or temporary basis and whether or not serving for compensation, shall be included within the terms "official or employee", regardless of the place of residence or post of duty of such individual. An independent contractor would not ordinarily be considered to be an official or employee. For purposes of this section, the term "foreign country" shall include any foreign nation, or

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political subdivision thereof, or any corporation or other entity serving as an instrumentality of such foreign country. Whether such nation has been accorded diplomatic recognition by the United States shall not be taken into account. Any individual or individuals who purport to be a government of a foreign nation shall be treated under this section as a foreign country, whether or not such individual or group of individuals in fact controls such foreign nation, and whether or not such individual or group is accorded diplomatic recognition. Accordingly, a group in rebellion against an established government shall be treated as a foreign country as shall the government against which the group is in rebellion.

(d) *Laws of the United States.* The term "laws of the United States", to which reference is made in paragraph (a) of this section, shall be deemed to include only Federal statutes, and legislative and interpretative regulations thereunder. The term shall also be limited to statutes which prohibit some act or acts, for the violation of which there is a civil or criminal penalty. A deduction shall not be disallowed under section 162(c) and this section for a payment which contravenes a governmentally declared public policy of the United States, unless payment would be in violation of the laws of the United States, if such laws were applicable. However, a deduction may be disallowed because its allowance would frustrate such governmentally declared policy without regard to section 162(c) or this section.

§ 1.163 Statutory provisions; interest.

SEC. 163. *Interest*—(a) *General rule.* There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) *Installment purchases where interest charge is not separately stated*—(1) *General rule.* If personal property is purchased under a contract—

(A) Which provides that payment of part or all of the purchase price is to be made in installments, and

(B) In which carrying charges are separately stated but the interest charge cannot be ascertained,

then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(2) *Limitation.* In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) *Cross references.* (1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265 (2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

§ 1.163–1 Interest deduction in general.

(a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

(c) Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing taxable income. (See, however, section 533.) In the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income.

§ 1.163–2 Installment purchases where interest charge is not separately stated.

(a) *In general.* Whenever there is a contract for the purchase of personal property providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. Section 163 (b) contains a formula, described in paragraph (b) of this section, in accordance with which the amount of interest deductible in the taxable year must be computed. This formula is designed to operate automatically in the case of any installment purchase, without regard to whether payments under the contract are made when due or are in default. For applicable limitations when an obligation to pay is terminated, see paragraph (c) of this section.

(b) *Computation.* The portion of any such payments to be treated as interest shall be equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of this computation, the average unpaid balance under the contract is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(c) *Limitations.* The amount treated as interest under section 163 (b) and this section for any taxable year shall not exceed the amount of the payments made under the contract during the taxable year nor the aggregate carrying charges properly attributable to each contract for such taxable year. In computing the amount to be treated as interest if the obligation to pay is terminated as, for example, in the case of a repossession of the property, the unpaid balance on the first day of the month during which the obligation is terminated shall be zero.

(d) *Illustrations.* The provisions of this section may be illustrated by the following examples:

Example (1). On January 20, 1955, A purchased a television set for $400, including a stated carrying charge of $25. The down payment was $50, and the balance was paid in 14 monthly installments of $25 each, on the 20th day of each month commencing with February. Assuming that A is a cash method, calendar year taxpayer and that no other installment purchases were made, the amount to be treated as interest in 1955 is $12.38, computed as follows:

YEAR 1955

First day of:	*Unpaid balance outstanding*
January	$0
February	350
March	325
April	300
May	275
June	250
July	225
August	200
September	175
October	150
November	125
December	100
	2,475

Sum of unpaid balances $2,475÷12=$206.25; 6 percent thereof=$12.38.

Example (2). On November 20, 1955, B purchased a furniture set for $1,250, including a stated carrying charge of $48. The down payment was $50 and the balance was payable in 12 monthly installments of $100 each, on the first day of each month commencing with December 1955. Assume that B is a cash method, calendar year taxpayer and that no other installment purchases were made. Assume further that B made the first payment when due, but made only one other payment on June 1, 1956. The amount to be treated as interest in 1955 is $4, and the amount to be treated as interest in 1956 is $33, computed as follows:

YEAR 1955

First day of:	*Unpaid balance outstanding*
December	$1,200

Sum of unpaid balances $1,200÷12=$100; 6 percent thereof=$6.

Carrying charges attributable to 1955=$4.

YEAR 1956

First day of:	*Unpaid balance outstanding*
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July	500
August	400
September	300
October	200
November	100
	6,600

Sum of unpaid balances $6,600 ÷ 12 = $550; 6 percent thereof = $33.

Carrying charges attributable to 1956 = $44 ($4 × 11).

Example (3). Assume the same facts as in example (2), except that the furniture was repossessed and B's obligation to pay terminated as of July 15, 1956. The amount to be treated as interest in 1955 is $4, computed as in example (2) above. The amount to be treated as interest in 1956 is $25.50, computed as follows:

YEAR 1956

First day of:	*Unpaid balance outstanding*
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July–November	0
	5,100

Sum of unpaid balances $5,100 ÷ 12 = $425. 6 percent thereof = $25.50.

Carrying charges attributable to 1956 = $44 ($4 × 11).

(e) *Effective date.* The provisions of section 163 are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954. The rule provided in section 163 (b) and this section applies to payments made during such taxable years regardless of when the contract of sale was made.

§ 1.164 Statutory provisions; taxes.

SEC. 164. *Taxes*—(a) *General rule.* Except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year.

(b) *Deduction denied in case of certain taxes.* No deduction shall be allowed for the following taxes:

(1) Federal income taxes, including—

(A) The tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act);

(B) The taxes imposed by sections 3201 and 3211 (relating to the taxes on railroad employees and railroad employee representatives); and

(C) The tax withheld at source on wages under section 3402, and corresponding provisions of prior revenue laws.

(2) Federal war profits and excess profits taxes.

(3) Federal import duties, and Federal excise and stamp taxes (not described in paragraph (1), (2), (4), or (5)); but this paragraph shall not prevent such duties and taxes from being deducted under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).

(4) Estate, inheritance, legacy, succession, and gift taxes.

(5) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent—

(A) The deduction of so much of such taxes as is properly allocable to maintenance or interest charges; or

(B) The deduction of taxes levied by a special taxing district if—

(i) The district covers the whole of at least one county;

(ii) At least 1,000 persons are subject to the taxes levied by the district; and

(iii) The district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

(6) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901 (relating to the foreign tax credit).

(7) Taxes on real property, to the extent that subsection (d) requires such taxes to be treated as imposed on another taxpayer.

(c) *Certain retail sales taxes and gasoline taxes*—(1) *General rule.* In the case of any State or local sales tax, if the amount of the tax is separately stated, then, to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount shall be allowed as a deduction to the consumer as if it constituted a tax imposed on, and paid by, such consumer.

(2) *Definition.* For purposes of paragraph (1), the term "State or local sales tax" means a tax imposed by a State, a Territory, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia, which tax—

(A) Is imposed on persons engaged in selling tangible personal property at retail (or on persons selling gasoline or other motor vehicle fuels at wholesale or retail) and is a stated sum per unit of property sold or is measured either by the gross sales price or by the gross receipts from the sale; or

(B) Is imposed on persons engaged in furnishing services at retail and is measured by the gross receipts for furnishing such services.

(d) *Apportionment of taxes on real property between seller and purchaser*—(1) *General rule.* For purposes of subsection (a), if real property is sold during any real property tax year, then—

(A) So much of the real property tax as is properly allocable to that part of such year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and

(B) So much of such tax as is properly allocable to that part of such year which begins on the date of the sale shall be treated as a tax imposed on the purchaser.

(2) *Special rules.* (A) In the case of any sale of real property, if—

(i) A taxpayer may not, by reason of his method of accounting, deduct any amount for taxes unless paid, and

(ii) The other party to the sale is (under the law imposing the real property tax) liable for the real property tax for the real property tax year,

then for purposes of subsection (a) the taxpayer shall be treated as having paid, on the date of the sale, so much of such tax as, under paragraph (1) of this subsection, is treated as imposed on the taxpayer. For purposes of the preceding sentence, if neither party is liable for the tax, then the party holding the property at the time the tax becomes a lien on the property shall be considered liable for the real property tax for the real property tax year.

(B) Paragraph (1) shall apply to taxable years ending after December 31, 1953, but only in the case of sales after December 31, 1953.

(C) Paragraph (1) shall not apply to any real property tax, to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for a taxable year which ended before January 1, 1954.

(D) In the case of any sale of real property, if the taxpayer's taxable income for the taxable year during which the sale occurs is computed under an accrual method of accounting, and if no election under section 461 (c) (relating to the accrual of real property taxes) applies, then, for purposes of subsection (a), that portion of such tax which—

(i) Is treated, under paragraph (1) of this subsection, as imposed on the taxpayer, and

(ii) May not, by reason of the taxpayer's method of accounting, be deducted by the taxpayer for any taxable year,

shall be treated as having accrued on the date of the sale.

(e) *Taxes of shareholder paid by corporation.* Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) The deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) No deduction shall be allowed the shareholder for such tax.

(f) *Payments for municipal services in atomic energy communities.* For purposes of this section, amounts paid or accrued, to compensate the Atomic Energy Commission for municipal-type services, by any owner of real property within any community (within the meaning of section 21b of the Atomic Energy Community Act of 1955) shall be treated as real property taxes paid or accrued. For purposes of this subsection, the term "owner" includes a person who holds the real property under a leasehold of 40 or more years and a person who has entered into a contract to purchase under section 61 of the Atomic Energy Community Act of 1955. Subsection (d) of this section shall not apply to a sale by the United States of property with respect to which this subsection applies.

(g) *Cross reference.* For provisions disallowing any deduction for the payment of the tax imposed by subchapter B of chapter 3 (relating to tax-free covenant bonds) see section 1451 (f).

[Sec. 164(f) as added by sec. 6, Technical Amendments Act 1958 (72 Stat. 1608)]

§ 1.164–1 Deduction for taxes.

Except as otherwise provided in this section and in §§ 1.164–2 to 1.164–8, inclusive, taxes imposed by the United States, any State, Territory, possession of the United States, or a political subdivision of any of the foregoing, or by any foreign country, are deductible from gross income for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income. See section 461 for the general rule for taxable year of deduction. Amounts paid to States or Territories under secured-debts laws in order to render securities tax-exempt are deductible. Automobile license fees are ordinarily taxes. Postage is not a tax. In general, taxes are deductible only by the person upon whom they are imposed. See section 164 (d) and § 1.164–6 for apportionment of taxes on real property between seller and purchaser. For provisions disallowing any deduction for the tax paid at the source on interest from tax-free covenant bonds, see section 1451 (f).

§ 1.164–2 Deduction denied in case of certain taxes.

This section and §§ 1.164–3 and 1.164–4 describe certain taxes for which no deduction is allowed or with respect to which the allowance of the deduction is subject to certain conditions. No deduction is allowed for:

(a) Federal income taxes, including the taxes imposed by section 3101, relating to the tax on employees under the Federal Insurance Contributions Act (chapter 21 of the Code); sections 3201 and 3211, relating to the taxes on railroad employees and railroad employee representatives; section 3402, relating to the tax withheld at source on wages; and by corresponding provisions of prior internal revenue laws.

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(b) Federal war profits and excess profits taxes including those imposed by Title II of the Revenue Act of 1917 (39 Stat. 1000), Title III of the Revenue Act of 1918 (40 Stat. 1088), Title III of the Revenue Act of 1921 (42 Stat. 271), section 216 of the National Industrial Recovery Act (48 Stat. 208), section 702 of the Revenue Act of 1934 (48 Stat. 770), subchapter D, chapter 1 of the Internal Revenue Code of 1939, and subchapter E, chapter 2 of the Internal Revenue Code of 1939.

(c) Estate, inheritance, legacy, succession, and gift taxes.

(d) Income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and of possessions of the United States.

(e) Taxes on real property, to the extent that section 164 (d) and § 1.164–6 require such taxes to be treated as imposed on another taxpayer.

§ 1.164–3 Federal duties and excise taxes.

No deduction is allowed under section 164 for Federal import or tariff duties, business, license, privilege, excise, and stamp taxes (not described in paragraph (a), (b), or (c) of § 1.164–2, or § 1.164–4), paid or accrued within the taxable year. The fact that any such tax is not deductible as a tax under section 164 does not prevent (a) its deduction under section 162 or section 212, provided it represents an ordinary and necessary expense paid or incurred during the taxable year by a corporation or an individual in the conduct of any trade or business or, in the case of an individual, for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, or (b) its being taken into account during the taxable year by a corporation or an individual as a part of the cost of acquiring or producing property in the trade or business or, in the case of an individual, as a part of the cost of property held for the production of income with respect to which it relates.

§ 1.164–4 Taxes for local benefits.

(a) Except as provided in paragraph (b) of this section, so-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation, and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. For treatment of assessments for local benefits as adjustments to the basis of property see section 1016 (a) (1) and the regulations thereunder.

(b) (1) Insofar as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.

(2) Taxes levied by a special taxing district are deductible if the district covers the whole of at least one county, if at least 1,000 persons are subject to the taxes levied by the district, and if the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

§ 1.164–5 Certain retail sales taxes and gasoline taxes.

(a) Any amount representing a State or local sales tax paid by a consumer of services or tangible personal property is deductible by such consumer as a tax, provided it is separately stated and not paid in connection with his trade or business. The fact that, under the law imposing it, the incidence of the State or local sales tax does not fall on the consumer is immaterial. The requirement of section 164(c)(1) that the amount of the tax must be separately stated will be deemed complied with where it clearly appears that at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purpose of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. Where the law imposing the State or local sales tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the State or local sales tax was separately stated at the time paid by the consumer; except that such presumption shall have no application to a gasoline tax imposed upon a wholesaler unless such provisions of law apply with respect to both the sale at wholesale and the sale at retail.

(b) As used in this section the term "State or local sales tax" means a tax imposed by a State, a Territory, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia upon persons engaged in selling tangible personal property at retail, or on persons selling gasoline or other motor vehicle fuels at wholesale or retail, which is a stated sum per unit of such property sold or which is measured by the gross sales price or the gross receipts from the sale. The term also includes a tax imposed by such authorities upon persons engaged in furnishing services at retail, which is measured by the gross receipts for furnishing such services.

(c) In general, the term "consumer" means the ultimate user or purchaser; it does not include a purchaser, such as a retailer, who acquires the property for resale.

§ 1.164–6 Apportionment of taxes on real property between seller and purchaser.

(a) *Scope.* Except as provided otherwise in section 164(f) and § 1.164–8, when real property is sold, section 164(d)(1) governs the deduction by the seller and the purchaser of current real property taxes. Section 164(d)(1) performs two functions: (1) It provides a method by which a portion of the taxes for the real property tax year in which the property is sold may be deducted by the seller and a portion by the purchaser; and (2) it limits the deduction of the seller and the purchaser to the portion of the taxes corresponding to the part of the real property tax year during which each was the owner of the property. These functions are accomplished by treating a portion of the taxes for the real property tax year in which the property is sold as imposed on the seller and a portion as imposed on the purchaser. To the extent that the taxes are treated as imposed on the seller and the purchaser, each shall be allowed a deduction, under section 164 (a), in the taxable year such tax is paid or accrued, or treated as paid or accrued under section 164 (d) (2) (A) or (D) and this section. No deduction is allowed for taxes on real property to the extent that they are imposed on another taxpayer, or are treated as imposed on another taxpayer under section 164(d). For the election to accrue real property taxes ratably see section 461 (c) and the regulations thereunder.

(b) *Application of rule of apportionment.* (1) (i) For purposes of the deduction provided by section 164 (a), if real property is sold during any real property tax year, the portion of the real property tax properly allocable to that part of the real property tax year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and the portion of such tax properly allocable to that part of such real property tax year which begins on the date of the sale shall be treated as a tax imposed on the purchaser. For definition of "real property tax year" see paragraph (c) of this section. This rule shall apply whether or not the seller and the purchaser apportion such tax. The rule of apportionment contained in section 164 (d) (1) applies even though the same real property is sold more than

once during the real property tax year. (See paragraph (d) (5) of this section for rule requiring inclusion in gross income of excess deductions.)

(ii) Where the real property tax becomes a personal liability or a lien before the beginning of the real property tax year to which it relates and the real property is sold subsequent to the time the tax becomes a personal liability or a lien but prior to the beginning of the related real property tax year—

(*a*) The seller may not deduct any amount for real property taxes for the related real property tax year, and

(*b*) To the extent that he holds the property for such real property tax year, the purchaser may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the seller, mortgagee, trustee or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iii) Similarly, where the real property tax becomes a personal liability or a lien after the end of the real property tax year to which it relates and the real property is sold prior to the time the tax becomes a personal liability or a lien but after the end of the related real property tax year—

(*a*) The purchaser may not deduct any amount for real property taxes for the related real property tax year, and

(*b*) To the extent that he holds the property for such real property tax year, the seller may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iv) Where the real property is sold (or purchased) during the related real property tax year the real property taxes for such year are apportioned between the parties to such sale and may be deducted by such parties in accordance with the provisions of paragraph (d) of this section.

(2) Section 164 (d) does not apply to delinquent real property taxes for any real property tax year prior to the real property tax year in which the property is sold.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (*1*). The real property tax year in County R is April 1 to March 31. A, the owner on April 1, 1954, of real property located in County R sells the real property to B on June 30, 1954. B owns the real property from June 30, 1954, through March 31, 1955. The real property tax for the real property tax year April 1, 1954–March 31, 1955 is $365. For purposes of section 164 (a), $90 (90/365 × $365, April 1, 1954–June 29, 1954) of the real property tax is treated as imposed on A, the seller, and $275 (275/365 × $365, June 30, 1954–March 31, 1955) of such real property tax is treated as imposed on B, the purchaser.

Example (*2*). In County S the real property tax year is the calendar year. The real property tax becomes a lien on June 1 and is payable on July 1 of the current real property tax year, but there is no personal liability for such tax. On April 30, 1955, C, the owner of real property in County S on January 1, 1955, sells the real property to D. On July 1, 1955, D pays the 1955 real property tax. On August 31, 1955, D sells the same real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164 (d) (1), 119/365 (January 1–April 29, 1955) of the real property tax payable on July 1, 1955, for the 1955 real property tax year is treated as imposed on C, and, under the provisions of section 164 (d) (2) (A), such portion is treated as having been paid by him on the date of sale. Under the provisions of section 164 (d) (1), 123/365 (April 30–August 30, 1955) of the real property tax paid July 1, 1955, for the 1955 real property tax year is treated as imposed on D and may be deducted by him. Under the provisions of section 164 (d) (1), 123/365 (August 31–December 31, 1955) of the real property tax due and paid on July 1, 1955, for the 1955 real property tax year is treated as imposed on E and, under the provisions of section 164 (d) (2) (A) such portion is treated as having been paid by him on the date of sale.

Example (*3*). In State X the real property tax year is the calendar year. The real property tax becomes a lien on November 1 of the preceding calendar year. On November 15, 1955, F sells real property in State X to G. G owns the real property through December 31, 1956. Under section 164 (d) (1), the real property tax (which became a lien on November 1, 1954) for the 1955 real property tax year is apportioned between F and G. No part of the real property tax for the 1956 real property tax year may be deducted by F. The entire real property tax for the 1956 real property tax year may be deducted by G when paid or accrued, depending upon the method of accounting used by him. See subparagraph (6) of paragraph (d) and section 461 (c) and the regulations thereunder.

(c) *Real property tax year.* As used in section 164 (d), the term "real property tax year" refers to the period which, under the law imposing the tax, is regarded as the period to which the tax imposed relates. Where the State and one or more local governmental units each imposes a tax on real property, the real property tax year for each tax must be determined for purposes of applying the rule of apportionment of section 164 (d) (1) to each tax. The time when the tax rate is determined, the time when the assessment is made, the time when the tax becomes a lien, or the time when the tax becomes due or delinquent does not necessarily determine the real property tax year. The real property tax year may or may not correspond to the fiscal year of the governmental unit imposing the tax. In each case the State or local law determines what constitutes the real property tax year. Although the seller and the purchaser may or may not make an allocation of real property taxes, the meaning of "real property tax year" in section 164 (d) and the application of section 164 (d) do not depend upon what real property taxes were allocated nor the method of allocation used by the parties.

(d) *Special rules*—(1) *Seller using cash receipts and disbursements method of accounting.* Under the provisions of section 164 (d), if the seller by reason of his method of accounting may not deduct any amount for taxes unless paid, and—

(i) The purchaser (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, or

(ii) The seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year and the tax is not payable until after the date of sale,

then the portion of the tax treated under section 164 (d) (1) as imposed upon the seller (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security.

(2) *Purchasers using the cash receipts and disbursements method of accounting.* Under the provisions of section 164 (d), if the purchaser by reason of his method of accounting may not deduct any amount for taxes unless paid and the seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, the portion of the tax treated under section 164 (d) (1) as imposed upon the purchaser (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the seller, mortgagee, trustee, or other person having an interest in the property as security.

(3) *Persons considered liable for tax.* Where the tax is not a liability of any person, the person who holds the property at the time the tax becomes a lien on the property shall be considered liable for the tax. As to a particular sale, in determining:

(i) Whether the other party to the sale is liable for the tax or,

(ii) The person who holds the property at the time the tax becomes a lien on the property (where the tax is not a liability of any person),

prior or subsequent sales of the property during the real property tax year shall be disregarded.

(4) *Examples.* The provisions of subparagraphs (1), (2), and (3) of this paragraph may be illustrated as follows:

Example (*1*). In County X the real property tax year is the calendar year. The real property tax is a personal liability of the owner of the real property on June 30 of the current real property tax year, but is not payable until February 28 of the following real property tax year. A, the owner of real property in County X on January 1, 1955, uses the cash receipts and disbursements method of accounting. On May 30, 1955, A sells the real property to B, who also uses the cash

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receipts and disbursements method of accounting. B retains ownership of the real property for the balance of the 1955 calendar year. Under the provisions of section 164 (d) (1), 149/365 (January 1–May 29, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on A, the seller, and under the provisions of section 164 (d) (2) (A) such portion is treated as having been paid by him on the date of sale and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164 (d) (1), 216/365 (May 30–December 31, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on B, the purchaser, and may be deducted by him for his taxable year in which the tax is actually paid, or an amount representing such tax is paid.

Example (2). In County Y, the real property tax year is the calendar year. The real property tax becomes a lien on January 1, 1955, and is payable on April 30, 1955. There is no personal liability for the real property tax imposed by County Y. On April 30, 1955, C, the owner of real property in County Y on January 1, 1955, pays the real property tax for the 1955 real property tax year. On May 1, 1955, C sells the real property to D. On September 1, 1955, D sells the real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164 (d) (1), 120/365 (January 1–April 30, 1955) of the real property tax is treated as imposed upon C and may be deducted by him for his taxable year in which the tax is actually paid. Under section 164 (d) (1), 123/365 (May 1–August 31, 1955) of the real property tax is treated as imposed upon D and, under the provisions of section 164 (d) (2) (A), is treated as having been paid by him on May 1, 1955, and may be deducted by D for his taxable year in which the sale from C to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid. Since, according to paragraph (d) (3) of this section, the prior sale by C to D is disregarded, under the provisions of section 164 (d) (1), 122/365 (September 1–December 31, 1955) of the real property tax is treated as imposed on E and, under the provisions of section 164 (d) (2) (A), is treated as having been paid by him on September 1, 1955, and may be deducted by E for his taxable year in which the sale from D to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid.

Example (3). In County X the real property tax year is the calendar year and the real property taxes are assessed and become a lien on June 30 of the current real property tax year, but are not payable until September 1 of that year. There is no personal liability for the real property tax imposed by County X. A, the owner on January 1, 1955, of real property in County X, uses the cash receipts and disbursements method of accounting. On July 15, 1955, A sells the real property to B. Under the provisions of section 164 (d) (1), 195/365 (January 1–July 14, 1955) of the real property tax payable on September 1, 1955, for the 1955 real property tax year is treated as imposed on A, and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164 (d) (1), 170/365 (July 15–December 31, 1955) of the real property tax is treated as imposed on B and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which the tax is actually paid or an amount representing such tax is paid.

(5) *Treatment of excess deduction.* If, for a taxable year prior to the taxable year of sale of real property, a taxpayer has deducted an amount for real property tax in excess of the portion of such real property tax treated as imposed on him under the provisions of section 164(d), the excess of the amount deducted over the portion treated as imposed on him shall be included in his gross income for the taxable year of the sale, subject to the provisions of section 111, relating to the recovery of bad debts, prior taxes, and delinquency amounts. The provisions of this subparagraph may be illustrated as follows:

Example (1). In Borough Y the real property tax is due and payable on November 30 for the succeeding calendar year, which is also the real property tax year. On November 30, 1954, taxpayer A, who reports his income on a calendar year under the cash receipts and disbursements method of accounting, pays the real property tax on real property owned by him in Borough Y for the 1955 real property tax year. On June 30, 1955, A sells the real property. Under the provisions of section 164 (d), only 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and the excess of the amount of real property tax for 1955 deducted by A, on his 1954 income tax return, over the 180/365 portion of such tax treated as imposed on him under section 164 (d), must be included in gross income in A's 1955 income tax return, subject to the provisions of section 111.

Example (2). In County Z the real property tax year is the calendar year. The real property tax becomes a personal liability of the owner of real property on January 1 of the current real property tax year, and is payable on July 1 of the current real property tax year. On May 1, 1955, A, the owner of real property in County Z on January 1, 1955, sells the real property to B. On November 1, 1955, B sells the same real property to C. B uses the cash receipts and disbursements method of accounting and reports his income on the basis of a fiscal year ending July 31. B, on July 1, 1955, pays the entire real property tax for the real property tax year ending December 31, 1955. Under the provisions of section 164 (d), only 184/365 (May 1–October 31, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on B, and the excess of the amount of real property tax for 1955 deducted by B on his income tax return for the fiscal year ending July 31, 1955, over the 184/365 portion of such tax treated as imposed on him under section 164 (d), must be included in gross income in B's income tax return for his fiscal year ending July 31, 1956, subject to the provisions of section 111.

(6) *Persons using an accrual method of accounting.* Where real property is sold and the seller or the purchaser computes his taxable income (for the taxable year during which the sale occurs) on an accrual method of accounting, then, if the seller or the purchaser has not made the election provided in section 461 (c) (relating to the accrual of real property taxes), the portion of any real property tax which is treated as imposed on him and which may not be deducted by him for any taxable year by reason of his method of accounting shall be treated as having accrued on the date of sale. The provisions of this subparagraph may be illustrated as follows:

Example. In County X the real property tax becomes a lien on property and is assessed on November 30 for the current calendar year, which is also the real property tax year. There is no personal liability for the real property tax imposed by County X. A owns, on January 1, 1955, real property in County X. A uses an accrual method of accounting and has not made any election under section 461 (c) to accrue ratably real property taxes. A sells real property on June 30, 1955. By reason of A's method of accounting, he could not deduct any part of the real property tax for 1955 on the real property since he sold the real property prior to November 30, 1955, the accrual date. Under section 164 (d) (1), 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and under section 164 (d) (2) (D) that portion is treated as having accrued on June 30, 1955, and may be deducted by A for his taxable year in which such date falls. B, the purchaser from A, who uses an accrual method of accounting, has likewise not made an election under section 461 (c) to accrue real property taxes ratably. Under section 164 (d) (1), 185/365 of the real property taxes may be accrued by B on November 30, 1955, and deducted for his taxable year in which such date falls.

(7) *Cross references.* For determination of amount realized on a sale of real property, see section 1001 (b) and the regulations thereunder. For determination of basis of real property acquired by purchase, see section 1012 and the regulations thereunder.

(8) *Effective dates.* Section 164 (d) applies to taxable years ending after December 31, 1953, but only in the case of sales made after December 31, 1953. However, section 164 (d) does not apply to any real property tax to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for any taxable year which ended before January 1, 1954.

§ 1.164–7 Taxes of shareholder paid by corporation.

Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such cases no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

§ 1.164–8 Payments for municipal services in atomic energy communities.

(a) *General.* For taxable years beginning after December 31, 1957, amounts paid or accrued by any owner of real property within any community (as defined in section 21b of the Atomic Energy Community Act of 1955 (42 U.S.C. 2304)) to compensate the Atomic Energy Commission for municipal-type services (or any agent or contractor authorized by the Atomic Energy Commission to charge for such services) shall be treated as real property taxes paid or accrued for purposes of section 164. Such amounts shall be deductible

as taxes to the extent provided in section 164, §§ 1.164–1 through 1.164–7, and this section. See paragraph (b) of this section for definition of the term "Atomic Energy Commission"; paragraph (c) of this section for the definition of the term "municipal-type services"; and paragraph (d) of this section for the definition of the term "owner".

(b) *Atomic Energy Commission.* For purposes of paragraph (a) of this section, the term "Atomic Energy Commission" shall mean—

(1) The Atomic Energy Commission, and

(2) Any other agency of the United States Government to which the duties and responsibilities of providing municipal-type services are delegated under the authority of section 101 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2313).

(c) *Municipal-type services.* For purposes of paragraph (a) of this section, the term "municipal-type services" includes services usually rendered by a municipality and usually paid for by taxes. Examples of municipal-type services are police protection, fire protection, public recreational facilities, public libraries, public schools, public health, public welfare, and the maintenance of roads and streets. The term shall include sewage and refuse disposal which are maintained out of revenues derived from a general charge for municipal-type services; however, the term shall not include sewage and refuse disposal if a separate charge for such services is made. Charges assessed against local benefits of a kind tending to increase the value of the property assessed are not charges for municipal-type services. See section 164(b)(5) and § 1.164–4.

(d) *Owner.* For purposes of paragraph (a) of this section, the term "owner" includes a person who holds the real property under a leasehold of 40 or more years from the Atomic Energy Commission (or any agency of the United States Government to which the duties and responsibilities of leasing real property are delegated under section 101 of the Atomic Energy Community Act of 1955), and a person who has entered into a contract to purchase under section 61 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2361). An assignee (either immediate or more remote) of a lessee referred to in the preceding sentence will also qualify as an owner for purposes of paragraph (a) of this section.

(e) *Nonapplication of section 164(d).* Section 164(d) and § 1.164–6, relating to apportionment of taxes on real property between seller and purchaser, do not apply to a sale by the United States or any of its agencies of real property to which section 164(f) and this section apply. Thus, amounts paid or accrued which qualify under paragraph (a) of this section will continue to be deductible as taxes to the extent provided in this section, even in the taxable year in which the owner actually purchases the real property from the United States or any of its agencies. However, the provisions of section 164(d) and § 1.164–6 shall apply to a sale of real property to which section 164(f) and this section apply, if the seller is other than the United States or any of its agencies.

§ 1.165 Statutory provisions; losses.

SEC. 165. *Losses*—(a) *General rule.* There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of deduction.* For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on losses of individuals.* In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. No loss described in this paragraph shall be allowed if, at the time of the filing of the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) *Wagering losses.* Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) *Theft losses.* For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) *Capital losses.* Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) *Worthless securities*—(1) *General rule.* If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) *Security defined.* For purposes of this subsection, the term "security" means—

(A) A share of stock in a corporation;

(B) A right to subscribe for, or to receive, a share of stock in a corporation; or

(C) A bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) *Securities in affiliated corporation.* For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) At least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) More than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

(h) *Cross references.* (1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g)(2)(C) applies, if issued by a political party or similar organization, see section 271.

(3) For special rule for losses on stock in a small business investment company, see section 1242.

(4) For special rule for losses of a small business investment company, see section 1243.

(5) For special rule for losses on small business stock, see section 1244.

[Sec. 165 as amended by secs. 7 and 57(c)(1), Technical Amendments Act 1958 (72 Stat. 1608, 1646); sec. 202(a), Small Business Tax Revision Act 1958 (72 Stat. 1676)]

§ 1.165–1 Losses.

(a) *Allowance of deduction.* Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder.

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) *Amount deductible.* (1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011–1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by § 1.1011–1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of § 1.1053–1.

(2) The amount of loss recognized upon the sale or exchange of property shall be determined for purposes of section 165(a) in accordance with § 1.1002–1.

(3) A loss from the sale or exchange of a capital asset shall be allowed as a deduction under section 165(a) but only to the extent allowed in section 1211, relating to the limitation on capital losses, and section 1212, relating to the capital loss carryover, and in the regulations under those sections.

(4) In determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for any insurance or other compensation received.

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which

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the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year.

(2)(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(ii) If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of $10,000 is completely destroyed by fire in 1961, and if the taxpayer's only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 1962, the taxpayer sustains a loss of $2,000 in 1961. However, if the taxpayer's automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 1962, $1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 1963.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted.

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see § 1.165–8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

(4) The rules of this paragraph are applicable with respect to a casualty or other event which may result in a loss and which occurs after January 16, 1960. If the casualty or other event occurs on or before such date, a taxpayer may treat any loss resulting therefrom in accordance with the rules then applicable, or, if he so desires, in accordance with the provisions of this paragraph; but no provision of this paragraph shall be construed to permit a deduction of the same loss or any part thereof in more than one taxable year or to extend the period of limitations within which a claim for credit or refund may be filed under section 6511.

(e) *Limitation on losses of individuals.* In the case of an individual, the deduction for losses granted by section 165(a) shall, subject to the provisions of section 165(c) and paragraph (a) of this section, be limited to:

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business and not incurred in any transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft, and if the loss involved has not been allowed for estate tax purposes in the estate tax return. For additional provisions pertaining to the allowance of casualty and theft losses, see §§ 1.165–7 and 1.165–8, respectively.

§ 1.165–2 Obsolescence of nondepreciable property.

(a) *Allowance of deduction.* A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

(b) *Exceptions.* This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken under section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

(c) *Cross references.* For the allowance under section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see § 1.167(a)–8. For provisions respecting the obsolescence of depreciable property, see § 1.167(a)–9. For the allowance of casualty losses, see § 1.165–7.

§ 1.165–3 Demolition of buildings.

(a) *Intent to demolish formed at time of purchase.* (1) Except as provided in subparagraph (2) of this paragraph, the following rule shall apply when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the buildings situated thereon: No deduction shall be allowed under section 165(a) on account of the demolition of the old buildings even though any demolition originally planned is subsequently deferred or abandoned. The entire basis of the property so purchased shall, notwithstanding the provisions of § 1.167(a)–5, be allocated to the land only. Such basis shall be increased by the net cost of demolition or decreased by the net proceeds from demolition.

(2)(i) If the property is purchased with the intention of demolishing the buildings and the buildings are used in a trade or business or held for the production of income before their demolition, a portion of the basis of the property may be allocated to such buildings and depreciated over the period during which they are so used or held. The fact that the taxpayer intends to demolish the buildings shall be taken into account in making the apportionment of basis between the land and buildings under § 1.167(a)–5. In any event, the portion of the purchase price which may be allocated to the buildings shall not exceed the present value of the right to receive rentals from the buildings over the period of their intended use. The present value of such right shall be determined at the time that the buildings are first used in the trade or business or first held for the production of income. If the taxpayer does not rent the buildings, but uses them in his own trade or business or in the production of his income, the present value of such right shall be determined by reference to the rentals which could be realized during such period of intended use. The fact that the taxpayer intends to rent or use the buildings for a limited period before their demolition shall also be taken into account in computing the useful life in accordance with paragraph (b) of § 1.167(a)–1.

(ii) Any portion of the purchase price which is allocated to the buildings in accordance with this subparagraph shall not be included in the basis of the land computed under subparagraph (1) of this paragraph, and any portion of the basis of the buildings which has not been recovered through depreciation or otherwise at the time of the demolition of the buildings is allowable as a deduction under section 165.

(iii) The application of this subparagraph may be illustrated by the following example:

Example. In January 1958, A purchased land and a building for $60,000 with the intention of demolishing the building. In the following April, A concludes that he will be unable to commence the construction of a proposed new building for a period of more than 3 years. Accordingly, on June 1, 1958, he leased the building for a period of 3 years at an annual rental of $1,200. A intends to demolish the building upon expiration of the lease. A may allocate a portion of the $60,000 basis of the property to the building to be depreciated over the 3-year period. That portion is equal to the present value of the right to receive $3,600 (3 times $1,200). Assuming that the present value of that right determined as of June 1, 1958, is $2,850, A may allocate that amount to the building and, if A files his return on the basis of a taxable year ending May 31, 1959, A may take a depreciation deduction with respect to such building of $950 for such taxable year. The basis of the land to A as determined under subparagraph (1) of this paragraph is reduced by $2,850. If on June 1, 1960, A ceases to rent the building and demolishes it, the balance of the undepreciated portion allocated to the buildings, $950, may be dededucted from gross income under section 165.

(3) The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property originally purchased even though such part was, at the time of purchase, allocated to the buildings to be demolished for purposes of determining allowable depreciation for the period before demolition.

(b) *Intent to demolish formed subsequent to the time of acquisition.* (1) Except as provided in subparagraph (2) of this paragraph, the loss incurred in a trade or business or in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under section 165(a) if the demolition occurs as a result of a plan formed subsequent to the acquisition of the buildings demolished. The amount of the loss shall be the adjusted basis of the buildings demolished increased by the net cost of demolition or decreased by the net proceeds from demolition. See paragraph (c) of § 1.165–1 relating to amount deductible under section 165. The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property demolished.

(2) If a lessor or lessee of real property demolishes the buildings situated thereon pursuant to the requirements of a lease or the requirements of an agreement which resulted in a lease, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. However, the adjusted basis of the demolished buildings, increased by the net cost of demolition or decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the term thereof.

(c) *Evidence of intention.* (1) Whether real property has been purchased with the intention of demolishing the buildings thereon or whether the demolition of the buildings occurs as a result of a plan formed subsequent to their acquisition is a question of fact, and the answer depends upon an examination of all the surrounding facts and circumstances. The answer to the question does not depend solely upon the statements of the taxpayer at the time he acquired the property or demolished the buildings, but such statements, if made, are relevant and will be considered. Certain other relevant facts and circumstances that exist in some cases and the inferences that might reasonably be drawn from them are described in subparagraphs (2) and (3) of this paragraph. The question as to the taxpayer's intention is not answered by any inference that is drawn from any one fact or circumstance but can be answered only by a consideration of all relevant facts and circumstances and the reasonable inferences to be drawn therefrom.

(2) An intention at the time of acquisition to demolish may be suggested by:

(i) A short delay between the date of acquisition and the date of demolition;

(ii) Evidence of prohibitive remodeling costs determined at the time of acquisition;

(iii) Existence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes;

(iv) Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or

(v) Inability at the time of acquisition to realize a reasonable income from the buildings.

(3) The fact that the demolition occurred pursuant to a plan formed subsequent to the acquisition of the property may be suggested by:

(i) Substantial improvement of the buildings immediately after their acquisition;

(ii) Prolonged use of the buildings for business purposes after their acquisition;

(iii) Suitability of the buildings for investment purposes at the time of acquisition;

(iv) Substantial change in economic or business conditions after the date of acquisition;

(v) Loss of useful value occurring after the date of acquisition;

(vi) Substantial damage to the buildings occurring after their acquisition;

(vii) Discovery of latent structural defects in the buildings after their acquisition;

(viii) Decline in the taxpayer's business after the date of acquisition;

(ix) Condemnation of the property by municipal authorities after the date of acquisition; or

(x) Inability after acquisition to obtain building material necessary for the improvement of the property.

§ 1.165–4 Decline in value of stock.

(a) *Deduction disallowed.* No deduction shall be allowed under section 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause. A mere shrinkage in the value of stock owned by the taxpayer, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as the date of loss. No loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized under § 1.1002–1 upon the sale or exchange of the stock and except as otherwise provided in § 1.165–5 with respect to stock which becomes worthless during the taxable year.

(b) *Stock owned by banks.* (1) In the regulation of banks and certain other corporations, Federal and State authorities may require that stock owned by such organizations be charged off as worthless or written down to a nominal value. If, in any such case, this requirement is premised upon the worthlessness of the stock, the charging off or writing down will be considered prima facie evidence of worthlessness for purposes of section 165(a); but, if the charging off or writing down is due to a fluctuation in the market price of the stock or if no reasonable attempt to determine the worthlessness of the stock has been made, then no deduction shall be allowed under section 165(a) for the amount so charged off or written down.

(2) This paragraph shall not be construed, however, to permit a deduction under section 165(a) unless the stock owned by the bank or other corporation actually becomes worthless in the taxable year. Such a taxpayer owning stock which becomes worthless during the taxable year is not precluded from deducting the loss under section 165(a) merely because, in obedience to the specific orders or general policy of such supervisory authorities, the value of the stock is written down to a nominal amount instead of being charged off completely.

(c) *Application to inventories.* This section does not apply to a decline in the value of corporate stock reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

(d) *Definition.* As used in this section, the term "stock" means a share of stock in a corporation or a right to subscribe for, or to receive, a share of stock in a corporation.

§ 1.165–5 Worthless securities.

(a) *Definition of security.* As used in section 165(g) and this section, the term "security" means:

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

(b) *Ordinary loss.* If any security which is not a capital asset becomes

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wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

(c) *Capital loss.* If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c)(3) of § 1.165–1.

(d) *Loss on worthless securities of an affiliated corporation*—(1) *Deductible as an ordinary loss.* If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of subparagraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1). A debt which becomes wholly worthless during the taxable year shall be allowed as an ordinary loss in accordance with the provisions of this subparagraph, to the extent that such debt is a security within the meaning of paragraph (a)(3) of this section.

(2) *Affiliated corporation defined.* For purposes of this paragraph, a corporation shall be treated as affiliated with the taxpayer owning the security if:

(i) The taxpayer owns directly at least 95 percent of each class of the stock of such corporation,

(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3), and

(iii) More than 90 percent of the aggregate of the gross receipts of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of such corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. For this purpose, the term "gross receipts" means total receipts determined without any deduction for cost of goods sold, and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from such sales or exchanges.

(e) *Bonds issued by an insolvent corporation.* A bond of an insolvent corporation secured only by a mortgage from which nothing is realized for the bondholders on foreclosure shall be regarded as having become worthless not later than the year of the foreclosure sale, and no deduction in respect of the loss shall be allowed under section 165(a) in computing a bondholder's taxable income for a subsequent year. See also paragraph (d) of § 1.165–1.

(f) *Decline in market value.* A taxpayer possessing a security to which this section relates shall not be allowed any deduction under section 165(a) on account of mere market fluctuation in the value of such security. See also § 1.165–4.

(g) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any security reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

(h) *Special rules for banks.* For special rules applicable under this section to worthless securities of a bank, including securities issued by an affiliated bank, see § 1.582–1.

(i) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 100 percent of each class of the stock of Y Corporation; and, in addition, 4 percent of the common stock (the only class of stock) of Z Corporation, which it acquired in 1948. Y Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 96 percent of the common stock of Z Corporation, which it acquired in 1946. It is established that the stock of Z Corporation, which has from its inception derived all its gross receipts from manufacturing operations, became worthless during 1956.

(ii) Since the stock of Z Corporation which is owned by X Corporation is a capital asset and since X Corporation does not directly own at least 95 percent of the stock of Z Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1956, of a capital asset. The loss so sustained by X Corporation shall be considered a long-term capital loss under the provisions of section 1222(4), since the stock was held by that corporation for more than 6 months.

(iii) Since Z Corporation is considered to be affiliated with Y Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by Y Corporation upon the worthlessness of the stock of Z Corporation shall be deducted in 1956 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss.

Example (2). (i) On January 1, 1956, X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 80 percent of each class of the stock of Y Corporation, a foreign corporation, which it acquired in 1950. Y Corporation has, from the date of its incorporation, derived all of its gross receipts from manufacturing operations. It is established that the stock of Y Corporation became worthless on June 30, 1956. On August 1, 1956, X Corporation acquires the balance of the stock of Y Corporation for the purpose of obtaining the benefit of section 165(g)(3) with respect to the loss it has sustained on the worthlessness of the stock of Y Corporation.

(ii) Since the stock of Y Corporation which is owned by X Corporation is a capital asset and since Y Corporation is not to be treated as affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, notwithstanding the fact that, at the close of 1956, X Corporation owns 100 percent of each class of stock of Y Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under the provisions of section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1956, of a capital asset.

Example (3). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 95 percent of each class of the stock of Y Corporation, which from its inception has derived all of its gross receipts from manufacturing operations. As one of its capital assets, X Corporation owns $100,000 in registered bonds issued by Y Corporation payable at maturity on December 31, 1960. It is established that these bonds became worthless during 1956.

(ii) Since Y Corporation is considered to be affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by X Corporation upon the worthlessness of these bonds may be deducted in 1956 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss. The loss may not be deducted under section 166 as a bad debt. See section 166(e).

§ 1.165–6 Farming losses.

(a) *Allowance of losses.* (1) Except as otherwise provided in this section, any loss incurred in the operation of a farm as a trade or business shall be allowed as a deduction under section 165(a) or as a net operating loss deduction in accordance with the provisions of section 172. See § 1.172–1.

(2) If the taxpayer owns and operates a farm for profit in addition to being engaged in another trade or business, but sustains a loss from the operation of the farming business, then the amount of loss sustained in the operation of the farm may be deducted from gross income, if any, from all other sources.

(3) Loss incurred in the operation of a farm for recreation or pleasure shall not be allowed as a deduction from gross income. See § 1.162–12.

(b) *Loss from shrinkage.* If, in the course of the business of farming, farm products are held for a favorable market, no deduction shall be allowed under section 165(a) in respect of such products merely because of shrinkage in weight, decline in value, or deterioration in storage.

(c) *Loss of prospective crop.* The total loss by frost, storm, flood, or fire of a prospective crop being grown in the business of farming shall not be allowed as a deduction under section 165(a).

(d) *Loss of livestock*—(1) *Raised stock.* A taxpayer engaged in the business of raising and selling livestock, such as cattle, sheep, or horses, may not deduct as a loss under section 165(a) the value of animals that perish from among those which were raised on the farm.

(2) *Purchased stock.* The loss sustained upon the death by disease, exposure, or injury of any livestock purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a). See, also, paragraph (e) of this section.

(e) *Loss due to compliance with orders of governmental authority.* The loss sustained upon the destruction by order

of the United States, a State, or any other governmental authority, of any livestock, or other property, purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a).

(f) *Amount deductible*—(1) *Expenses of operation.* The cost of any feed, pasture, or care which is allowed under section 162 as an expense of operating a farm for profit shall not be included as a part of the cost of livestock for purposes of determining the amount of loss deductible under section 165(a) and this section. For the deduction of farming expenses, see § 1.162–12.

(2) *Losses reflected in inventories.* If inventories are taken into account in determining the income from the trade or business of farming, no deduction shall be allowed under this section for losses sustained during the taxable year upon livestock or other products, whether purchased for resale or produced on the farm, to the extent such losses are reflected in the inventory on hand at the close of the taxable year. Nothing in this section shall be construed to disallow the deduction of any loss reflected in the inventories of the taxpayer. For provisions relating to inventories of farmers, see section 471 and the regulations thereunder.

(3) *Other limitations.* For other provisions relating to the amount deductible under this section, see paragraph (c) of § 1.165–1, relating to the amount deductible under section 165(a); § 1.165–7, relating to casualty losses; and § 1.1231–1, relating to gains and losses from the sale or exchange of certain property used in the trade or business.

(g) *Other provisions applicable to farmers.* For other provisions relating to farmers, see § 1.61–4, relating to gross income of farmers; paragraph (b) of § 1.167(a)–6, relating to depreciation in the case of farmers; and § 1.175–1, relating to soil and water conservation expenditures.

§ 1.165–7 Casualty losses.

(a) *In general*—(1) *Allowance of deduction.* Except as otherwise provided in paragraph (c) of this section, any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. However, see § 1.165–6, relating to farming losses. The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit. The amount of a casualty loss shall be determined in accordance with paragraph (b) of this section. For other rules relating to the treatment of deductible casualty losses, see § 1.1231–1, relating to the involuntary conversion of property.

(2) *Method of valuation.* (i) In determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.

(ii) The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (*a*) the repairs are necessary to restore the property to its condition immediately before the casualty, (*b*) the amount spent for such repairs is not excessive, (*c*) the repairs do not care for more than the damage suffered, and (*d*) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

(3) *Damage to automobiles.* An automobile owned by the taxpayer, whether used for business purposes or maintained for recreation or pleasure, may be the subject of a casualty loss, including those losses specifically referred to in subparagraph (1) of this paragraph. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and when:

(i) The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf, or

(ii) The damage results from the faulty driving of the operator of the vehicle with which the automobile of the taxpayer collides.

(4) *Application to inventories.* This section does not apply to a casualty loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

(5) *Property converted from personal use.* In the case of property which originally was not used in the trade or business or for income-producing purposes and which is thereafter converted to either of such uses, the fair market value of the property on the date of conversion, if less than the adjusted basis of the property at such time, shall be used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss under paragraph (b)(1) of this section. See paragraph (b) of § 1.165–9, and § 1.167(f)–1.

(6) *Theft losses.* A loss which arises from theft is not considered a casualty loss for purposes of this section. See § 1.165–8, relating to theft losses.

(b) *Amount deductible*—(1) *General rule.* In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 165(a) shall be the lesser of either—

(i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or

(ii) The amount of the adjusted basis prescribed in § 1.1011–1 for determining the loss from the sale or other disposition of the property involved.

However, if property used in a trade or business or held for the production of income is totally destroyed by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated as the amount of the loss for purposes of section 165(a).

(2) *Aggregation of property for computing loss.* (i) A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) of this paragraph by reference to the single, identifiable property damaged or destroyed. Thus, for example, in determining the fair market value of the property before and after the casualty in a case where damage by casualty has occurred to a building and ornamental or fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and trees into account separately, and not together as an integral part of the realty, and separate losses shall be determined for such building and trees.

(ii) In determining a casualty loss involving real property and improvements thereon not used in a trade or business or in any transaction entered into for profit, the improvements (such as buildings and ornamental trees and shrubbery) to the property damaged or destroyed shall be considered an integral part of the property, for purposes of subparagraph (1) of this paragraph, and no separate basis need be apportioned to such improvements.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). In 1956 B purchases for $3,600 an automobile which he uses for nonbusiness purposes. In 1959 the automobile is damaged in an accidental collision with another automobile. The fair market value of B's automobile is $2,000 immediately before the collision and $1,500 immediately after the collision. B receives insurance proceeds of $300 to cover the loss. The amount of the deduction allowable under section 165(a) for the taxable year 1959 is $200, computed as follows:

Value of automobile immediately before casualty	$2,000
Less: Value of automobile immediately after casualty	1,500
Value of property actually destroyed	500
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($500) or adjusted basis of property ($3,600)	500
Less: Insurance received	300
Deduction allowable	200

Example (2). In 1958 A purchases land containing an office building for the lump sum of $90,000. The purchase price is allocated between the land ($18,000) and the building ($72,000) for purposes of determining basis. After the purchase A planted trees and ornamental shrubs on the grounds

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surrounding the building. In 1961 the land, building, trees, and shrubs are damaged by hurricane. At the time of the casualty the adjusted basis of the land is $18,000 and the adjusted basis of the building is $66,000. At that time the trees and shrubs have an adjusted basis of $1,200. The fair market value of the land and building immediately before the casualty is $18,000 and $70,000, respectively, and immediately after the casualty is $18,000 and $52,000, respectively. The fair market value of the trees and shrubs immediately before the casualty is $2,000 and immediately after the casualty is $400. In 1961 insurance of $5,000 is received to cover the loss to the building. A has no other gains or losses in 1961 subject to section 1231 and § 1.1231–1. The amount of the deduction allowable under section 165(a) with respect to the building for the taxable year 1961 is $13,000, computed as follows:

Value of property immediately before casualty	$70,000
Less: Value of property immediately after casualty	52,000
Value of property actually destroyed	18,000
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($18,000) or adjusted basis of property ($66,000)	$18,000
Less: Insurance received	5,000
Deduction allowable	13,000

The amount of the deduction allowable under section 165(a) with respect to the trees and shrubs for the taxable year 1961 is $1,200, computed as follows:

Value of property immediately before casualty	$2,000
Less: Value of property immediately after casualty	400
Value of property actually destroyed	1,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($1,600) or adjusted basis of property ($1,200)	1,200

Example (3). Assume the same facts as in example (2) except that A purchases land containing a house instead of an office building. The house is used as his private residence. Since the property is used for personal purposes, no allocation of the purchase price is necessary for the land and house. Likewise, no individual determination of the fair market values of the land, house, trees, and shrubs is necessary. The amount of the deduction allowable under section 165(a) with respect to the land, house, trees, and shrubs for the taxable year 1961 is $14,600, computed as follows:

Value of property immediately before casualty	$90,000
Less: Value of property immediately after casualty	70,400
Value of property actually destroyed	19,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($19,600) or adjusted basis of property ($91,200)	19,600
Less: Insurance received	5,000
Deduction allowable	14,600

(c) *Loss sustained by an estate.* A casualty loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is sustained during the settlement of an estate shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)–1. See section 165(c)(3).

(d) *Loss treated as though attributable to a trade or business.* For the rule treating a casualty loss not connected with a trade or business as though it were a deduction attributable to a trade or business for purposes of computing a net operating loss, see paragraph (a)(3)(iii) of § 1.172–3.

(e) *Effective date.* The rules of this section are applicable to any taxable year beginning after January 16, 1960. If, for any taxable year beginning on or before such date, a taxpayer computed the amount of any casualty loss in accordance with the rules then applicable, such taxpayer is not required to change the amount of the casualty loss allowable for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax return for such year to compute the amount of a casualty loss in accordance with the provisions of this section, but no provision in this section shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

§ 1.165–8 Theft losses.

(a) *Allowance of deduction.* (1) Except as otherwise provided in paragraph (b) of this section, any loss arising from theft is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. See section 165(c)(3).

(2) A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165(e). Thus, a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, see paragraph (d) of § 1.165–1.

(3) The same theft loss shall not be taken into account both in computing a tax under chapter 1, relating to the income tax, or chapter 2, relating to additional income taxes, of the Internal Revenue Code of 1939 and in computing the income tax under the Internal Revenue Code of 1954. See section 7852(c), relating to items not to be twice deducted from income.

(b) *Loss sustained by an estate.* A theft loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is discovered during the settlement of an estate, even though the theft actually occurred during a taxable year of the decedent, shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)–1. See section 165(c)(3). For purposes of determining the year of deduction, see paragraph (a)(2) of this section.

(c) *Amount deductible.* The amount deductible under this section in respect of a theft loss shall be determined consistently with the manner prescribed in § 1.165–7 for determining the amount of casualty loss allowable as a deduction under section 165(a). In applying the provisions of paragraph (b) of § 1.165–7 for this purpose, the fair market value of the property immediately after the theft shall be considered to be zero. For other rules relating to the treatment of deductible theft losses, see § 1.1231–1, relating to the involuntary conversion of property.

(d) *Definition.* For purposes of this section the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

(e) *Application to inventories.* This section does not apply to a theft loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

(f) *Example.* The application of this section may be illustrated by the following example:

Example. In 1955 B, who makes her return on the basis of the calendar year, purchases for personal use a diamond brooch costing $4,000. On November 30, 1961, at which time it has a fair market value of $3,500, the brooch is stolen; but B does not discover the loss until January 1962. The brooch was fully insured against theft. A controversy develops with the insurance company over its liability in respect of the loss. However, in 1962, B has a reasonable prospect of recovery of the fair market value of the brooch from the insurance company. The controversy is settled in March 1963, at which time B receives $2,000 in insurance proceeds to cover the loss from theft. No deduction for the loss is allowable for 1961 or 1962; but the amount of the deduction allowable under section 165(a) for the taxable year 1963 is $1,500, computed as follows:

Value of property immediately before theft	$3,500
Less: Value of property immediately after the theft	0
Balance	3,500
Loss to be taken into account for purposes of section 165(a): ($3,500 but not to exceed adjusted basis of $4,000 at time of theft)	$3,500
Less: Insurance received in 1963	2,000
Deduction allowable for 1963	1,500

§ 1.165–9 Sale of residential property.

(a) *Losses not allowed.* A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a).

(b) *Property converted from personal use.* (1) If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to

with respect to the land, house, trees, and [illegible] as [illegible]

income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under section 165(a).

(2) The loss allowed under this paragraph upon the sale of the property shall be the excess of the adjusted basis prescribed in § 1.1011–1 for determining loss over the amount realized from the sale. For this purpose, the adjusted basis for determining loss shall be the lesser of either of the following amounts, adjusted as prescribed in § 1.1011–1 for the period subsequent to the conversion of the property to income-producing purposes:

(i) The fair market value of the property at the time of conversion, or

(ii) The adjusted basis for loss, at the time of conversion, determined under § 1.1011–1 but without reference to the fair market value.

(3) For rules relating to casualty losses of property converted from personal use, see paragraph (a)(5) of § 1.165–7. To determine the basis for depreciation in the case of such property, see § 1.167(f)–1. For limitations on the loss from the sale of a capital asset, see paragraph (c)(3) of § 1.165–1.

(c) *Examples.* The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Residential property is purchased by the taxpayer in 1943 for use as his personal residence at a cost of $25,000, of which $15,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1952, at which time its fair market value is $22,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1952, until January 1, 1955, at which time it is sold for $16,000. On January 1, 1952, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1955 is $4,200, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $25,000 cost or $22,000 fair market value)	$22,000
Less: Depreciation allowable from January 1, 1952, to January 1, 1955 (3 years at 5 percent based on $12,000, the value of the building at time of conversion, as prescribed by § 1.167(f)–1)	1,800
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	$20,000
Less: Amount realized on sale	16,000
Loss to be taken into account for purposes of section 165(a)	4,200

In this example the value of the building at the time of conversion is used as the basis for computing depreciation. See example (2) of this paragraph wherein the adjusted basis of the building is required to be used for such purpose.

Example (2). Residential property is purchased by the taxpayer in 1940 for use as his personal residence at a cost of $23,000, of which $10,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1953, at which time its fair market value is $20,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1953, until January 1, 1957, at which time it is sold for $17,000. On January 1, 1953, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1957 is $1,000, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $23,000 cost or $20,000 fair market value)	$20,000
Less: Depreciation allowable from January 1, 1953, to January 1, 1957 (4 years at 5 percent based on $10,000, the cost of the building, as prescribed by § 1.167(f)–1	2,000
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	18,000
Less: Amount realized on sale	17,000
Loss to be taken into account for purposes of section 165(a)	1,000

§ 1.165–10 Wagering losses.

Losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions. In the case of a husband and wife making a joint return for the taxable year, the combined losses of the spouses from wagering transactions shall be allowed to the extent of the combined gains of the spouses from wagering transactions.

§ 1.166 Statutory provisions; bad debts.

SEC. 166. *Bad debts*—(a) *General rule*—(1) *Wholly worthless debts.* There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.* When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of deduction.* For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Reserve for bad debts.* In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(d) *Nonbusiness debts*—(1) *General rule.* In the case of a taxpayer other than a corporation—

(A) Subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) Where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) *Nonbusiness debt defined.* For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) A debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) *Worthless securities.* This section shall not apply to a debt which is evidenced by a security as defined in section 165 (g)(2)(C).

(f) *Guarantor of certain noncorporate obligations.* A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

(g) *Cross references.* (1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

(3) For special rule for bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 593.

[Sec. 166 as amended by sec. 8, Technical Amendments Act 1958 (72 Stat. 1608)]

§ 1.166–1 Bad debts.

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) *Manner of selecting method.* (1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of § 1.446–1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change the method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt

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which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166.

(d) *Amount deductible*—(1) *General rule.* Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by § 1.1011–1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of § 1.1053–1.

(2) *Specific cases.* Subject to any provision of section 166 and the regulations thereunder which provides to the contrary, the following amounts are deductible as bad debts:

(i) *Notes or accounts receivable.* (*a*) If, in computing taxable income, a taxpayer values his notes or accounts receivable at their fair market value when received, the amount deductible as a bad debt under section 166 in respect of such receivables shall be limited to such fair market value even though it is less than their face value.

(*b*) A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is based upon the price he paid for such receivables but not upon their face value.

(ii) *Bankruptcy claim.* Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted under section 166 as a bad debt.

(iii) *Claim against decedent's estate.* The excess of the amount of the claim over the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate may be considered a worthless debt under section 166.

(e) *Prior inclusion in income required.* Worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under section 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.

(f) *Recovery of bad debts.* Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of § 1.111–1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

(g) *Worthless securities.* (1) Section 166 and the regulations thereunder do not apply to a debt which is evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. See section 166(e). For provisions allowing the deduction of a loss resulting from the worthlessness of such a debt, see § 1.165–5.

(2) The provisions of subparagraph (1) of this paragraph do not apply to any loss sustained by a bank and resulting from the worthlessness of a security described in section 165(g)(2)(C). See paragraph (a) of § 1.582–1.

§ 1.166–2 Evidence of worthlessness.

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

(b) *Legal action not required.* Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

(c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

(2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

(d) *Banks and other regulated corporations*—(1) *Worthlessness presumed in year of charge-off.* If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part in obedience to the specific orders of such supervisory authorities, then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year. But no such debt shall be so conclusively presumed to be worthless, or worthless only in part, as the case may be, if the amount so charged off is not claimed as a deduction by the taxpayer at the time of filing the return for the taxable year in which the charge-off takes place.

(2) *Evidence of worthlessness in later taxable year.* If such a bank or other corporation does not claim a deduction for such a totally or partially worthless debt in its return for the taxable year in which the charge-off takes place, but claims the deduction for a later taxable year, then the charge-off in the prior taxable year shall be deemed to have been involuntary and the deduction under section 166 shall be allowed for the taxable year for which claimed, provided that the taxpayer produces sufficient evidence to show that—

(i) The debt became wholly worthless in the later taxable year, or became recoverable only in part subsequent to the taxable year of the involuntary charge-off, as the case may be; and,

(ii) To the extent that the deduction claimed in the later taxable year for a debt partially worthless was not involuntarily charged off in prior taxable years, it was charged off in the later taxable year.

§ 1.166–3 Partial or total worthlessness.

(a) *Partial worthlessness*—(1) *Applicable to specific debts only.* A deduction under section 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.

(2) *Charge-off required.* (i) If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction under section 166(a)(2) but only to the extent charged off during the taxable year.

(ii) If a taxpayer claims a deduction for a part of a debt for the taxable year within which that part of the debt is charged off and the deduction is disallowed for that taxable year, then, in a case where the debt becomes partially worthless after the close of that taxable year, a deduction under section 166(a)(2) shall be allowed for a subsequent taxable year but not in excess of the amount charged off in the prior taxable year plus any amount charged off in the subsequent taxable year. In such instance, the charge-off in the prior taxable year shall, if consistently maintained as such, be sufficient to that extent to meet the charge-off requirement of section 166(a)(2) with respect to the subsequent taxable year.

(iii) Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

(b) *Total worthlessness.* If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction from gross income for any prior taxable year shall be allowed as a deduction for the current taxable year.

§ 1.166–4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166–1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What con-

stitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.* A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) *Special rule applicable to certain banking organizations.* For special rule for the addition to the bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see § 1.593–1.

§ 1.166–5 Nonbusiness debts.

(a) *Allowance of deduction as capital loss.* (1) The loss resulting from any nonbusiness debt's becoming partially or wholly worthless within the taxable year shall not be allowed as a deduction under either section 166(a) or section 166(c) in determining the taxable income of a taxpayer other than a corporation. See section 166(d)(1)(A).

(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. Such a loss is subject to the limitations provided in section 1211, relating to the limitation on capital losses, and section 1212, relating to the capital loss carryover, and in the regulations under those sections. A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165–5, relating to losses on worthless securities.

(c) *Guaranty of corporate obligations.* For provisions treating a loss sustained by a guarantor of the obligations of a corporation as a loss resulting from the worthlessness of a nonbusiness debt, see paragraph (b) of § 1.166–8.

(d) *Examples.* The application of this section may be illustrated by the following examples involving a case where A, an individual who is engaged in the grocery business and who makes his return on the basis of the calendar year, extends credit to B in 1955 on an open account:

Example (1). In 1956 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1957. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business.

Example (2). In 1956 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example (3). In 1956 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands in 1957. C's loss is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim, or create or acquire it in connection with his trade or business, the loss is sustained as a proximate incident to the conduct of the trade or business in which he is engaged at the time the debt becomes worthless.

Example (4). In 1956 A dies, leaving the business to his son, C, but leaving the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example (5). In 1956 A dies; and, while his executor, C, is carrying on the business, the claim against B becomes worthless in 1957. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim on behalf of the estate, or create or acquire it in connection with a trade or business in which the estate is engaged, the loss is sustained as a proximate incident to the conduct of the trade or business in which the estate is engaged at the time the debt becomes worthless.

Example (6). In 1956, A, in liquidating the business, attempts to collect the claim against B but finds that it has become worthless. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business and since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

§ 1.166–6 Sale of mortgaged or pledged property.

(a) *Deficiency deductible as bad debt*—(1) *Principal amount.* If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount under section 166(a) (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it becomes wholly worthless or is charged off as partially worthless. See § 1.166–3.

(2) *Accrued interest.* Accrued interest may be included as part of the deduction allowable under this paragraph, but only if it has previously been returned as income.

(b) *Realization of gain or loss*—(1) *Determination of amount.* If, in the case of a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.

(2) *Fair market value defined.* The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer.

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(c) *Basis of property purchased.* If the creditor subsequently sells the property so acquired, the basis for determining gain or loss upon the subsequent sale is the fair market value of the property at the date of its acquisition by the creditor.

§ 1.166–7 Worthless bonds issued by an individual.

(a) *Allowance of deduction.* A bond or other similar obligation issued by an individual, if it becomes worthless in whole or in part, is subject to the bad debt provisions of section 166. The loss from the worthlessness of any such bond or obligation is deductible in accordance with section 166(a), unless such bond or obligation is a nonbusiness debt as defined in section 166(d)(2). If the bond or obligation is a nonbusiness debt, it is subject to section 166(d) and § 1.166–5.

(b) *Decline in market value.* A taxpayer possessing debts evidenced by bonds or other similar obligations issued by an individual shall not be allowed any deduction under section 166 on account of mere market fluctuation in the value of such obligations.

(c) *Worthless bonds issued by corporation.* For provisions allowing the deduction under section 165(a) of the loss sustained upon the worthlessness of any bond or similar obligation issued by a corporation or a government, see § 1.165–5.

(d) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any bond or similar obligation reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

§ 1.166–8 Losses of guarantors, endorsers, and indemnitors.

(a) *Noncorporate obligations*—(1) *Deductible as bad debt.* A payment during the taxable year by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of an obligation issued by a person other than a corporation shall, for purposes of section 166 and the regulations thereunder, be treated as a debt's becoming worthless within the taxable year, if—

(i) The proceeds of the obligation so issued have been used in the trade or business of the borrower, and

(ii) The borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment except for the existence of the guaranty, endorsement, or indemnity, whether or not such obligation has in fact become worthless within the taxable year in which payment is made.

(2) *Nonbusiness debt rule not applicable.* If a payment is treated as a loss in accordance with the provisions of subparagraph (1) of this paragraph, section 166(d), relating to the special rule for losses sustained on the worthlessness of a nonbusiness debt, shall not apply. Accordingly, in each instance the loss shall be deducted under section 166(a)(1) as a wholly worthless debt even though there has been a discharge of only a part of the taxpayer's obligation. Thus, if the taxpayer makes a payment during the taxable year in discharge of only part of his obligation as a guarantor, endorser, or indemnitor, he may treat such payment under section 166(a)(1) as a debt's becoming wholly worthless within the taxable year, provided that he can establish that such part of the borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment and the conditions of subparagraph (1) of this paragraph have otherwise been satisfied.

(3) *Other applicable provisions.* Other provisions of the internal revenue laws relating to bad debts, such as section 111, relating to the recovery of bad debts, shall be deemed to apply to any payment which, under the provisions of this paragraph, is treated as a bad debt. If the requirements of section 166(f) are not met, any loss sustained by a guarantor, endorser, or indemnitor upon the worthlessness of the debtor's obligation shall be treated under the provisions of law applicable thereto. See, for example, paragraph (b) of this section.

(b) *Corporate obligations.* The loss sustained during the taxable year by a taxpayer other than a corporation in discharge of all of his obligation as a guarantor of an obligation issued by a corporation shall be treated, in accordance with section 166(d) and the regulations thereunder, as a loss sustained on the worthlessness of a nonbusiness debt if the debt created in the guarantor's favor as a result of the payment does not come within the exceptions prescribed by section 166(d)(2) (A) or (B). See paragraph (a)(2) of § 1.166–5.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to the X Bank being wholly worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment during that year.

Example (2). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. In 1956, B pays a part of his obligation to the X Bank but defaults on the remaining part. In 1957, A makes payment to the X Bank, in discharge of part of his obligation as a guarantor, of the remaining unpaid part of B's obligation to the bank, such part of B's obligation then being worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment of the remaining unpaid part of B's obligation.

Example (3). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used for B's personal use. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to X Bank being wholly worthless. A may not apply the benefit of section 166(f) to his loss, since the proceeds of B's obligation have not been used in B's trade or business.

Example (4). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of Y Corporation to the X Bank, the proceeds of the obligation being used in Y Corporation's business. Y Corporation defaults on its obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of Y Corporation to the X Bank being wholly worthless. At no time during 1955 or 1957 is A engaged in a trade or business. For his taxable year 1957, A is entitled to deduct a capital loss in accordance with the provisions of section 166(d) and paragraph (a)(2) of § 1.166–5. He may not apply the benefit of section 166(f) to his loss, since his payment is in discharge of an obligation issued by a corporation.

§ 1.167(a) Statutory provisions; depreciation; general rule.

SEC. 167. *Depreciation*—(a) *General rule.* There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) Of property used in the trade or business, or

(2) Of property held for the production of income.

§ 1.167(a)–1 Depreciation in general.

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167 (f) and § 1.167 (f)–1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not

a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167 (d) and § 1.167 (d)–1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, paragraph (a) of § 1.167 (b)–2 for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167 (b)–1, 1.167(b)–2, and 1.167(b)–3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

§ 1.167(a)–2 Tangible property.

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

§ 1.167(a)–3 Intangibles.

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

§ 1.167(a)–4 Leased property.

Capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. If the useful life of such improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under section 167. See §§ 1.167 (b)–0, 1.167 (b)–1, 1.167 (b)–2, 1.167 (b)–3, and 1.167 (b)–4 for methods of computing such depreciation allowances. If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, the allowances shall take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining of the term of the lease. Such deductions shall be in lieu of allowances for depreciation. See section 162 and the regulations thereunder. Capital expenditures made by a lessor for the erection of buildings or other improvements shall, if subject to depreciation allowances, be recovered by him over the estimated life of the improvements without regard to the period of the lease.

§ 1.167(a)–5 Apportionment of basis.

In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law.

§ 1.167(a)–6 Depreciation in special cases.

(a) *Depreciation of patents or copyrights.* The cost or other basis of a patent or copyright shall be depreciated over its remaining useful life. Its cost to the patentee includes the various Government fees, cost of drawings, models, attorneys' fees, and similar expenditures. For rules applicable to research and experimental expenditures, see sections 174 and 1016 and the regulations thereunder. If a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year.

(b) *Depreciation in case of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

§ 1.167(a)–7 Accounting for depreciable property.

(a) Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account. Assets may be grouped in an account in a variety of ways. For example, assets similar in kind with approximately the same useful lives may be grouped together. Such an account is commonly known as a group account. Another appropriate grouping might consist of assets segregated according to

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use without regard to useful life, for example, machinery and equipment, furniture and fixtures, or transportation equipment. Such an account is commonly known as a classified account. A broader grouping, where assets are included in the same account regardless of their character or useful lives, is commonly referred to as a composite account. For example, all the assets used in a business may be included in a single account. Group, classified, or composite accounts may be further broken down on the basis of location, dates of acquisition, cost, character, use, etc.

(b) When group, classified, or composite accounts are used with average useful lives and a normal retirement occurs, the full cost or other basis of the asset retired, unadjusted for depreciation or salvage, shall be removed from the asset account and shall be charged to the depreciation reserve. Amounts representing salvage ordinarily are credited to the depreciation reserve. Where an asset is disposed of for reasons other than normal retirement, the full cost or other basis of the asset shall be removed from the asset account, and the depreciation reserve shall be charged with the depreciation applicable to the retired asset. For rules with respect to losses on normal retirements, see § 1.167 (a)–8.

(c) A taxpayer may establish as many accounts for depreciable property as he desires. Depreciation allowances shall be computed separately for each account. Such depreciation preferably should be recorded in a depreciation reserve account; however, in appropriate cases it may be recorded directly in the asset account. Where depreciation reserves are maintained, a separate reserve account shall be maintained for each asset account. The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of law relating to adjustments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of accounts reconciling the differences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors. Depreciation schedules filed with the income tax return shall show the accumulated reserves computed in accordance with the allowances for income tax purposes.

(d) In classified or composite accounts, the average useful life and rate shall be redetermined whenever additions, retirements, or replacements substantially alter the relative proportion of types of assets in the accounts. See example (2) in paragraph (b) of § 1.167 (b)–1 for method of determining the depreciation rate for a classified or composite account.

§ 1.167(a)–8 Retirements.

(a) *Gains and losses on retirements.* For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.* For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.* The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term "adjusted basis" means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of § 1.167 (a)–1.

(2) In the case of a normal retirement of an asset from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

(d) *Special rule for item accounts.* (1) As indicated in paragraph (a) (3) (ii) and (iii) of this section, a loss is recognized upon the normal retirement of an asset from a single asset account but a loss on the normal retirement of an asset in a multiple asset account is

not allowable where the depreciation rate is based upon the average useful life of the assets in the account. Where a taxpayer with more than one depreciable asset chooses to set up a separate account for each such asset and the depreciation rate is based on the average useful life of such assets (so that he uses the same life for each account), the question arises whether his depreciation deductions in substance are the equivalent of those which would result from the use of multiple asset accounts and, therefore, he should be subject to the rules governing losses on retirements of assets from multiple asset accounts. Where a taxpayer has only a few depreciable assets which he chooses to account for in single asset accounts, particularly where such assets cover a relatively narrow range of lives, it cannot be said in the usual case that the allowance of losses on retirements from such accounts clearly will distort income. This results from the fact that where a taxpayer has only a few depreciable assets it is usually not possible clearly to determine that the depreciation rate is based upon the average useful life of such assets. Accordingly, it cannot be said that the taxpayer is in effect clearly operating with a multiple asset account using an average life rate so that losses should not be allowed on normal retirements. Therefore, losses normally will be allowed upon retirement of assets from single asset accounts where the taxpayer has only a few depreciable assets. On the other hand, when a taxpayer who has only a few depreciable assets chooses to account for them in single asset accounts, using for each account a depreciation rate based on the average useful life of such assets, and the assets cover a wide range of lives, the likelihood that income will be distorted is greater than where the group of assets covers a relatively narrow range of lives. In those cases where the allowance of losses would distort income, the rules with respect to the allowance of losses on normal retirement shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(2) Where a taxpayer has a large number of depreciable assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, if instead of accounting for a large number of similar or dissimilar depreciable assets in multiple asset accounts, the taxpayer chooses to account separately for such assets, using a rate based upon the average life of such assets, the rules with respect to the allowances of losses on normal retirements will be applied to such assets in the same manner as though the assets were accounted for in multiple asset accounts using a rate based upon average expected useful life.

(3) Where a taxpayer who does not have a large number of depreciable assets (and who therefore is not subject to subparagraph (2) of this paragraph) chooses to set up a separate account for each such asset, and has sought to compute an average life for such assets on which to base his depreciation deductions (so that he uses the same life for each account), the allowance of losses on normal retirements from such accounts may in some situations substantially distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, where a taxpayer chooses to account separately for such assets instead of accounting for them in multiple asset accounts, and the result is to substantially distort his income, the rules with respect to the allowance of losses on normal retirements shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(4) Whenever a taxpayer is treated under this paragraph as though his assets were accounted for in a multiple asset account using an average life rate, and, therefore, he is denied a loss on retirements, the unrecovered cost less salvage of each asset which was accounted for separately may be amortized in accordance with the regulation stated in paragraph (e) (1) (ii) of this section.

(e) *Accounting treatment of asset retirements.* (1) In the case of a normal retirement where under the foregoing rules no loss is recognized and where the asset is retired without disposition or abandonment, (i) if the asset was contained in a multiple asset account, the full cost of such asset, reduced by estimated salvage, shall be charged to the depreciation reserve, or (ii) if the asset was accounted for separately, the unrecovered cost or other basis, less salvage, of the asset may be amortized through annual deductions from gross income in amounts equal to the unrecovered cost or other basis of such asset, divided by the average expected useful life (not the remaining useful life) applicable to the asset at the time of retirement. For example, if an asset is retired after six years of use and at the time of retirement depreciation was being claimed on the basis of an average expected useful life of ten years, the unrecovered cost or other basis less salvage would be amortized through equal annual deductions over a period of ten years from the time of retirement.

(2) Where multiple asset accounts are used and acquisitions and retirements are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income. Conversely, where the taxpayer customarily follows a practice of reporting all receipts from salvage as ordinary taxable income such practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income.

(f) *Cross reference.* For special rules in connection with the retirement of the last assets of a given year's acquisitions under the declining balance method, see example (2) in paragraph (b) of § 1.167 (b)–2.

§ 1.167(a)–9 Obsolescence.

The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)–8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)–1.

§ 1.167(a)–10 When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167 (b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account.

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For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention", that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167 (b)–1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§ 1.167(b) Statutory provisions; depreciation; use of certain methods and rates.

SEC. 167. *Depreciation.* • • •

(b) *Use of certain methods and rates.* For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) The straight line method,

(2) The declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) The sum of the years-digits method, and

(4) Any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

§ 1.167(b)–0 Methods of computing depreciation.

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167 (a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167 (b) and §§ 1.167 (b)–1, 1.167 (b)–2, 1.167 (b)–3, and 1.167 (b)–4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167 (c) and § 1.167 (c)–1. See also § 1.167 (e)–1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.* In the case of item accounts, any method which results in a reasonable allowance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified, or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167 (e)–1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and § 1.167 (c)–1 for restriction on the use of certain methods. See also § 1.167 (a)–7 for definition of account.

§ 1.167(b)–1 Straight line method.

(a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

(b) *Illustrations.* The straight line method is illustrated by the following examples:

Example (1). Under the straight line method items may be depreciated separately:

Year	Item	Cost or other basis less salvage	Useful life	Depreciation allowable		
				1954	1955	1956
1954	Asset A	$1,600	*Years* 4	[1] $200	$400	$400
	Asset B	12,000	40	[1] 150	300	300

[1] In this example it is assumed that the assets were placed in service on July 1, 1954.

Example (2). In group, classified, or composite accounting, a number of assets with the same or different useful lives may be combined into one account, and a single rate of depreciation, i. e., the group, classified, or composite rate used for the entire account. In the case of group accounts, i. e., accounts containing assets which are similar in kind and which have approximately the same estimated useful lives, the group rate is determined from the average of the useful lives of the assets. In the case of classified or composite accounts, the classified or composite rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

Cost or other basis	Estimated useful life	Annual depreciation
$10,000	*Years* 5	$2,000
10,000	15	667
20,000		2,667

Average rate is 13.33 percent ($2,667÷$20,000) unadjusted for salvage. Assuming the estimated salvage value is 10 percent of the cost or other basis, the rate adjusted for salvage will be 13.33 percent minus 10 percent of 13.33 percent (13.33%—1.33%), or 12 percent.

Example (3). The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be 6⅔ percent, resulting in an adjusted rate of 18.67 percent. During the years illus-

trated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

1954—Initial investment of $12,000.

1957—Retirement $2,000, salvage realized $200.

1958—Retirement $2,000, salvage realized $200.

1959—Retirement $4,000, salvage realized $400.

1959—Additions $10,000.

1960—Retirement $2,000, no salvage realized.

1961—Retirement $2,000, no salvage realized.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION ON AVERAGE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate (percent)	Allowable depreciation
1954		$12,000		$12,000	$6,000	18.67	$1,120
1955	$12,000			12,000	12,000	18.67	2,240
1956	12,000			12,000	12,000	18.67	2,240
1957	12,000		$2,000	10,000	11,000	18.67	2,054
1958	10,000		2,000	8,000	9,000	18.67	1,680
1959	8,000	10,000	4,000	14,000	11,000	18.67	2,054
1960	14,000		2,000	12,000	13,000	18.67	2,427
1961	12,000		2,000	10,000	11,000	18.67	2,054

CORRESPONDING DEPRECIATION RESERVE ACCOUNT

Year	Depreciation reserve Jan. 1	Depreciation allowable	Current retirements	Salvage realized	Depreciation reserve Dec. 31
1954		$1,120			$1,120
1955	$1,120	2,240			3,360
1956	3,360	2,240			5,600
1957	5,600	2,054	$2,000	$200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000		4,615
1961	4,615	2,054	2,000		4,669

§ 1.167(b)–2 Declining balance method.

(a) *Application of method.* Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167 (f), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167 (b) (2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See section 167 (c) and § 1.167 (c)–1 for restrictions on the use of the declining balance method.

(b) *Illustrations.* The declining balance method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of 20 years was purchased on January 1, 1954, for $1,000. The normal straight line rate (without adjustment for salvage) is 5 percent, and the declining balance rate at twice the normal straight line rate is 10 percent. The annual depreciation allowances for 1954, 1955, and 1956 are as follows:

Year	Basis	Declining balance rate (percent)	Depreciation allowance
1954	$1,000	10	$100
1955	900	10	90
1956	810	10	81

Example (2). A taxpayer filing his returns on a calendar year basis maintains a group account to which a 5 year life and a 40 percent declining balance rate are applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of § 1.167(b)–1. Although salvage value is not taken into consideration in computing a declining balance rate, it must be recognized and accounted for when assets are retired.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION USING AVERAGE ASSET AND RESERVE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Average reserve before depreciation	Net depreciable balance	Rate (percent)	Allowable depreciation
1954		$12,000		$12,000	$6,000		$6,000	40	$2,400
1955	$12,000			12,000	12,000	$2,400	9,600	40	3,840
1956	12,000			12,000	12,000	6,240	5,760	40	2,304
1957	12,000		$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000		2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000	10,000	4,000	14,000	11,000	5,212	5,788	40	2,315
1960	14,000		2,000	12,000	13,000	4,727	8,273	40	3,309
1961	12,000		2,000	10,000	11,000	6,036	4,964	40	1,986

DEPRECIATION RESERVE

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000		3,727	4,727	3,309	7,036
1961	7,036	2,000		5,036	6,036	1,986	7,022

Where separate depreciation accounts are maintained by year of acquisition and there is an unrecovered balance at the time of the last retirement, such unrecovered balance may be deducted as part of the depreciation allowance for the year of such retirement. Thus, if the taxpayer had kept separate depreciation accounts by year of acquisition and all the retirements shown in the example above were from 1954 acquisitions, depreciation would be computed on the 1954 and 1959 acquisitions as follows:

1954 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisitions	Current retirements	Asset balance Dec. 31	Average balance	Average reserve before depreciation	Net depreciable balance	Rate (percent)	Allowable depreciation
1954		$12,000		$12,000	$6,000		$6,000	40	$2,400
1955	$12,000			12,000	12,000	$2,400	9,600	40	3,840
1956	12,000			12,000	12,000	6,240	5,760	40	2,304
1957	12,000		$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000		2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000		4,000	4,000	6,000	5,212	788	40	315
1960	4,000		2,000	2,000	3,000	2,727	273	40	109
1961	2,000		2,000		1,000	836	164		[1] 164

[1] Balance allowable as depreciation in the year of retirement of the last survivor of the 1954 acquisitions.

DEPRECIATION RESERVE FOR 1954 ACQUISITIONS

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000		3,727	4,727	3,309	7,036
1961	7,036	2,000		5,036	6,036	1,986	7,022

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1959 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisition	Asset balance Dec. 31	Average balance	Reserve Dec. 31, before depreciation	Net depreciable balance	Rate (percent)	Allowable depreciation	Reserve Dec. 31, after depreciation
1959		$10,000	$10,000	$5,000	None	$5,000	40	$2,000	$2,000
1960	$10,000		10,000	10,000	$2,000	8,000	40	3,200	5,200
1961	10,000		10,000	10,000	5,200	4,800	40	1,920	7,120

In the above example, the allowable depreciation on the 1954 acquisitions totals $11,200. This amount when increased by salvage realized in the amount of $800, equals the entire cost or other basis of the 1954 acquisitions ($12,000).

(c) *Change in estimated useful life.* In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised useful life had been originally estimated. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20 percent is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originally determined as twelve years. Accordingly, the applicable depreciation rate will be 16⅔ percent. This rate is thereafter applied to the unrecovered cost or other basis.

§ 1.167(b)–3 Sum of the years-digits method.

(a) *Applied to a single asset*—(1) *General rule.* Under the sum of the years-digits method annual allowances for depreciation are computed by applying changing fractions to the cost or other basis of the property reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator which remains constant is the sum of all the years digits corresponding to the estimated useful life of the asset. See section 167 (c) and § 1.167 (c)–1 for restrictions on the use of the sum of the years-digits method.

(i) *Illustrations.* Computation of depreciation allowances on a single asset under the sum of the years-digits method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of five years was acquired on January 1, 1954, for $1,750. The estimated salvage is $250. For a taxpayer filing his returns on a calendar year basis, the annual depreciation allowances are as follows:

Year	Cost or other basis less salvage	Fraction [1]	Allowable depreciation	Depreciation reserve
1954	$1,500	5/15	$500	$500
1955	1,500	4/15	400	900
1956	1,500	3/15	300	1,200
1957	1,500	2/15	200	1,400
1958	1,500	1/15	100	1,500
Unrecovered value (salvage)				$250

[1] The denominator of the fraction is the sum of the digits representing the years of useful life, i. e., 5, 4, 3, 2, and 1, or 15.

Example (2). Assume in connection with an asset acquired in 1954 that three-fourths of a year's depreciation is allowable in that year. The following illustrates a reasonable method of allocating depreciation:

	Depreciation for 12 months	Allowable depreciation		
		1954	1955	1956
1st year	$500	(¾) $375	(¼) $125	
2d year	400		(¾) 300	(¼) $100
3d year	300			(¾) 225
		375	425	325

(ii) *Change in useful life.* Where in the case of a single asset, a change is justified in the useful life, subsequent computations shall be made as though the remaining useful life at the beginning of the taxable year of change were the useful life of a new asset acquired at such time and with a basis equal to the unrecovered cost or other basis of the asset at that time. For example, assume that a new asset with an estimated useful life of ten years is purchased in 1954. At the time of making out his return for 1959, the taxpayer finds that the asset has a remaining useful life of seven years from January 1, 1959. Depreciation for 1959 should then be computed as though 1959 were the first year of the life of an asset estimated to have a useful life of seven years, and the allowance for 1959 would be 7/28 of the unrecovered cost or other basis of the asset after adjustment for salvage.

(2) *Remaining life*—(i) *Application.* Under the sum of the years-digits method, annual allowances for depreciation may also be computed by applying changing fractions to the unrecovered cost or other basis of the asset reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the digits corresponding to the years of estimated remaining useful life of the asset. For decimal equivalents of such fractions, see Table I of subdivision (ii) of this subparagraph. For example, a new asset with an estimated useful life of 10 years is purchased January 1, 1954, for $6,000. Assuming a salvage value of $500, the depreciation allowance for 1954 is $1,000 ($5,500×0.1818, the applicable rate from Table I). For 1955, the unrecovered balance is $4,500, and the remaining life is 9 years. The depreciation allowance for 1955 would then be $900 ($4,500×0.2000, the applicable rate from Table I).

(ii) *Table I.* This table shows decimal equivalents of sum of the years-digits fractions corresponding to remaining lives from 1 to 100 years.

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE

Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent
100.0	0.0198	98.7	0.0201
99.9	.0198	98.6	.0201
99.8	.0198	98.5	.0201
99.7	.0199	98.4	.0201
99.6	.0199	98.3	.0201
99.5	.0199	98.2	.0202
99.4	.0199	98.1	.0202
99.3	.0199	98.0	.0202
99.2	.0200	97.9	.0202
99.1	.0200	97.8	.0202
99.0	.0200	97.7	.0203
98.9	.0200	97.6	.0203
98.8	.0200	97.5	.0203
97.4	0.0203	91.2	0.0217
97.3	.0203	91.1	.0217
97.2	.0204	91.0	.0217
97.1	.0204	90.9	.0218
97.0	.0204	90.8	.0218
96.9	.0204	90.7	.0218
96.8	.0204	90.6	.0218
96.7	.0205	90.5	.0219
96.6	.0205	90.4	.0219
96.5	.0205	90.3	.0219
96.4	.0205	90.2	.0219
96.3	.0206	90.1	.0220
96.2	.0206	90.0	.0220
96.1	.0206	89.9	.0220
96.0	.0206	89.8	.0220
95.9	.0206	89.7	.0221
95.8	.0207	89.6	.0221
95.7	.0207	89.5	.0221
95.6	.0207	89.4	.0221
95.5	.0207	89.3	.0221
95.4	.0207	89.2	.0222
95.3	.0208	89.1	.0222
95.2	.0208	89.0	.0222
95.1	.0208	88.9	.0222
95.0	.0208	88.8	.0223
94.9	.0209	88.7	.0223
94.8	.0209	88.6	.0223
94.7	.0209	88.5	.0223
94.6	.0209	88.4	.0224
94.5	.0209	88.3	.0224
94.4	.0210	88.2	.0224
94.3	.0210	88.1	.0224
94.2	.0210	88.0	.0225
94.1	.0210	87.9	.0225
94.0	.0211	87.8	.0225
93.9	.0211	87.7	.0225
93.8	.0211	87.6	.0226
93.7	.0211	87.5	.0226
93.6	.0211	87.4	.0226
93.5	.0212	87.3	.0226
93.4	.0212	87.2	.0227
93.3	.0212	87.1	.0227
93.2	.0212	87.0	.0227
93.1	.0213	86.9	.0228
93.0	.0213	86.8	.0228
92.9	.0213	86.7	.0228
92.8	.0213	86.6	.0228
92.7	.0213	86.5	.0229
92.6	.0214	86.4	.0229
92.5	.0214	86.3	.0229
92.4	.0214	86.2	.0229
92.3	.0214	86.1	.0230
92.2	.0215	86.0	.0230
92.1	.0215	85.9	.0230
92.0	.0215	85.8	.0230
91.9	.0215	85.7	.0231
91.8	.0216	85.6	.0231
91.7	.0216	85.5	.0231
91.6	.0216	85.4	.0231
91.5	.0216	85.3	.0232
91.4	.0216	85.2	.0232
91.3	.0217	85.1	.0232

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
85.0	0.0233
84.9	.0233
84.8	.0233
84.7	.0233
84.6	.0234
84.5	.0234
84.4	.0234
84.3	.0234
84.2	.0235
84.1	.0235
84.0	.0235
83.9	.0236
83.8	.0236
83.7	.0236
83.6	.0236
83.5	.0237
83.4	.0237
83.3	.0237
83.2	.0238
83.1	.0238
83.0	.0238
82.9	.0238
82.8	.0239
82.7	.0239
82.6	.0239
82.5	.0240
82.4	.0240
82.3	.0240
82.2	.0240
82.1	.0241
82.0	.0241
81.9	.0241
81.8	.0242
81.7	.0242
81.6	.0242
81.5	.0242
81.4	.0243
81.3	.0243
81.2	.0243
81.1	.0244
81.0	.0244
80.9	.0244
80.8	.0244
80.7	.0245
80.6	.0245
80.5	.0245
80.4	.0246
80.3	.0246
80.2	.0246
80.1	.0247
80.0	.0247
79.9	.0247
79.8	.0248
79.7	.0248
79.6	.0248
79.5	.0248
79.4	.0249
79.3	.0249
79.2	.0249
79.1	.0250
79.0	.0250
78.9	.0250
78.8	0.0251
78.7	.0251
78.6	.0251
78.5	.0252
78.4	.0252
78.3	.0252
78.2	.0253
78.1	.0253
78.0	.0253
77.9	.0253
77.8	.0254
77.7	.0254
77.6	.0254
77.5	.0255
77.4	.0255
77.3	.0255
77.2	.0256
77.1	.0256
77.0	.0256
76.9	.0257
76.8	.0257
76.7	.0257
76.6	.0258
76.5	.0258
76.4	.0258
76.3	.0259
76.2	.0259
76.1	.0259
76.0	.0260
75.9	.0260
75.8	.0260
75.7	.0261
75.6	.0261
75.5	.0261
75.4	.0262
75.3	.0262
75.2	.0262
75.1	.0263
75.0	.0263
74.9	.0264
74.8	.0264
74.7	.0264
74.6	.0265
74.5	.0265
74.4	.0265
74.3	.0266
74.2	.0266
74.1	.0266
74.0	.0267
73.9	.0267
73.8	.0267
73.7	.0268
73.6	.0268
73.5	.0268
73.4	.0269
73.3	.0269
73.2	.0270
73.1	.0270
73.0	.0270
72.9	.0271
72.8	.0271
72.7	.0271
72.6	0.0272
72.5	.0272
72.4	.0272
72.3	.0273
72.2	.0273
72.1	.0274
72.0	.0274
71.9	.0274
71.8	.0275
71.7	.0275
71.6	.0275
71.5	.0276
71.4	.0276
71.3	.0277
71.2	.0277
71.1	.0277
71.0	.0278
70.9	.0278
70.8	.0279
70.7	.0279
70.6	.0279
70.5	.0280
70.4	.0280
70.3	.0280
70.2	.0281
70.1	.0281
70.0	.0282
69.9	.0282
69.8	.0282
69.7	.0283
69.6	.0283
69.5	.0284
69.4	.0284
69.3	.0284
69.2	.0285
69.1	.0285
69.0	.0286
68.9	.0286
68.8	.0287
68.7	.0287
68.6	.0287
68.5	.0288
68.4	.0288
68.3	.0289
68.2	.0289
68.1	.0289
68.0	.0290
67.9	.0290
67.8	.0291
67.7	.0291
67.6	.0292
67.5	.0292
67.4	.0292
67.3	.0293
67.2	.0293
67.1	.0294
67.0	.0294
66.9	.0295
66.8	.0295
66.7	.0295
66.6	.0296
66.5	.0296
66.4	0.0297
66.3	.0297
66.2	.0298
66.1	.0298
66.0	.0299
65.9	.0299
65.8	.0299
65.7	.0300
65.6	.0300
65.5	.0301
65.4	.0301
65.3	.0302
65.2	.0302
65.1	.0303
65.0	.0303
64.9	.0303
64.8	.0304
64.7	.0304
64.6	.0305
64.5	.0305
64.4	.0306
64.3	.0306
64.2	.0307
64.1	.0307
64.0	.0308
63.9	.0308
63.8	.0309
63.7	.0309
63.6	.0310
63.5	.0310
63.4	.0311
63.3	.0311
63.2	.0312
63.1	.0312
63.0	.0313
62.9	.0313
62.8	.0313
62.7	.0314
62.6	.0314
62.5	.0315
62.4	.0315
62.3	.0316
62.2	.0316
62.1	.0317
62.0	.0317
61.9	.0318
61.8	.0318
61.7	.0319
61.6	.0319
61.5	.0320
61.4	.0320
61.3	.0321
61.2	.0322
61.1	.0322
61.0	.0323
60.9	.0323
60.8	.0324
60.7	.0324
60.6	.0325
60.5	.0325
60.4	.0326
60.3	.0326
60.2	0.0327
60.1	.0327
60.0	.0328
59.9	.0328
59.8	.0329
59.7	.0329
59.6	.0330
59.5	.0331
59.4	.0331
59.3	.0332
59.2	.0332
59.1	.0333
59.0	.0333
58.9	.0334
58.8	.0334
58.7	.0335
58.6	.0336
58.5	.0336
58.4	.0337
58.3	.0337
58.2	.0338
58.1	.0338
58.0	.0339
57.9	.0340
57.8	.0340
57.7	.0341
57.6	.0341
57.5	.0342
57.4	.0342
57.3	.0343
57.2	.0344
57.1	.0344
57.0	.0345
56.9	.0345
56.8	.0346
56.7	.0347
56.6	.0347
56.5	.0348
56.4	.0348
56.3	.0349
56.2	.0350
56.1	.0350
56.0	.0351
55.9	.0351
55.8	.0352
55.7	.0353
55.6	.0353
55.5	.0354
55.4	.0355
55.3	.0355
55.2	.0356
55.1	.0356
55.0	.0357
54.9	.0358
54.8	.0358
54.7	.0359
54.6	.0360
54.5	.0360
54.4	.0361
54.3	.0362
54.2	.0362
54.1	.0363
54.0	0.0364
53.9	.0364
53.8	.0365
53.7	.0366
53.6	.0366
53.5	.0367
53.4	.0368
53.3	.0368
53.2	.0369
53.1	.0370
53.0	.0370
52.9	.0371
52.8	.0372
52.7	.0372
52.6	.0373
52.5	.0374
52.4	.0374
52.3	.0375
52.2	.0376
52.1	.0377
52.0	.0377
51.9	.0378
51.8	.0379
51.7	.0379
51.6	.0380
51.5	.0381
51.4	.0382
51.3	.0382
51.2	.0383
51.1	.0384
51.0	.0385
50.9	.0385
50.8	.0386
50.7	.0387
50.6	.0388
50.5	.0388
50.4	.0389
50.3	.0390
50.2	.0391
50.1	.0391
50.0	.0392
49.9	.0393
49.8	.0394
49.7	.0394
49.6	.0395
49.5	.0396
49.4	.0397
49.3	.0398
49.2	.0398
49.1	.0399
49.0	.0400
48.9	.0401
48.8	.0402
48.7	.0402
48.6	.0403
48.5	.0404
48.4	.0405
48.3	.0406
48.2	.0406
48.1	.0407
48.0	.0408
47.9	.0409
47.8	0.0410
47.7	.0411
47.6	.0411
47.5	.0412
47.4	.0413
47.3	.0414
47.2	.0415
47.1	.0416
47.0	.0417
46.9	.0418
46.8	.0418
46.7	.0419
46.6	.0420
46.5	.0421
46.4	.0422
46.3	.0423
46.2	.0424
46.1	.0425
46.0	.0426
45.9	.0426
45.8	.0427
45.7	.0428
45.6	.0429
45.5	.0430
45.4	.0431
45.3	.0432
45.2	.0433
45.1	.0434
45.0	.0435
44.9	.0436
44.8	.0437
44.7	.0438
44.6	.0439
44.5	.0440
44.4	.0440
44.3	.0441
44.2	.0442
44.1	.0443
44.0	.0444
43.9	.0445
43.8	.0446
43.7	.0447
43.6	.0448
43.5	.0449
43.4	.0450
43.3	.0451
43.2	.0452
43.1	.0453
43.0	.0455
42.9	.0456
42.8	.0457
42.7	.0458
42.6	.0459
42.5	.0460
42.4	.0461
42.3	.0462
42.2	.0463
42.1	.0464
42.0	.0465
41.9	.0466
41.8	.0467
41.7	.0468
41.6	0.0469
41.5	.0471
41.4	.0472
41.3	.0473
41.2	.0474
41.1	.0475
41.0	.0476
40.9	.0477
40.8	.0478
40.7	.0480
40.6	.0481
40.5	.0482
40.4	.0483
40.3	.0484
40.2	.0485
40.1	.0487
40.0	.0488
39.9	.0489
39.8	.0490
39.7	.0491
39.6	.0493
39.5	.0494
39.4	.0495
39.3	.0496
39.2	.0497
39.1	.0499
39.0	.0500
38.9	.0501
38.8	.0502
38.7	.0504
38.6	.0505
38.5	.0506
38.4	.0508
38.3	.0509
38.2	.0510
38.1	.0511
38.0	.0513
37.9	.0514
37.8	.0515
37.7	.0517
37.6	.0518
37.5	.0519
37.4	.0521
37.3	.0522
37.2	.0524
37.1	.0525
37.0	.0526
36.9	.0528
36.8	.0529
36.7	.0530
36.6	.0532
36.5	.0533
36.4	.0535
36.3	.0536
36.2	.0538
36.1	.0539
36.0	.0541
35.9	.0542
35.8	.0543
35.7	.0545
35.6	.0546
35.5	.0548

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TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent
35.4	0.0549	29.2	0.0662
35.3	.0551	29.1	.0664
35.2	.0552	29.0	.0667
35.1	.0554	28.9	.0669
35.0	.0556	28.8	.0671
34.9	.0557	28.7	.0673
34.8	.0559	28.6	.0675
34.7	.0560	28.5	.0678
34.6	.0562	28.4	.0680
34.5	.0563	28.3	.0682
34.4	.0565	28.2	.0685
34.3	.0566	28.1	.0687
34.2	.0568	28.0	.0690
34.1	.0570	27.9	.0692
34.0	.0571	27.8	.0694
33.9	.0573	27.7	.0697
33.8	.0575	27.6	.0699
33.7	.0576	27.5	.0702
33.6	.0578	27.4	.0704
33.5	.0580	27.3	.0707
33.4	.0581	27.2	.0709
33.3	.0583	27.1	.0712
33.2	.0585	27.0	.0714
33.1	.0586	26.9	.0717
33.0	.0588	26.8	.0719
32.9	.0590	26.7	.0722
32.8	.0592	26.6	.0724
32.7	.0593	26.5	.0727
32.6	.0595	26.4	.0730
32.5	.0597	26.3	.0732
32.4	.0599	26.2	.0735
32.3	.0600	26.1	.0738
32.2	.0602	26.0	.0741
32.1	.0604	25.9	.0743
32.0	.0606	25.8	.0746
31.9	.0608	25.7	.0749
31.8	.0610	25.6	.0752
31.7	.0611	25.5	.0754
31.6	.0613	25.4	.0757
31.5	.0615	25.3	.0760
31.4	.0617	25.2	.0763
31.3	.0619	25.1	.0766
31.2	.0621	25.0	.0769
31.1	.0623	24.9	.0772
31.0	.0625	24.8	.0775
30.9	.0627	24.7	.0778
30.8	.0629	24.6	.0781
30.7	.0631	24.5	.0784
30.6	.0633	24.4	.0787
30.5	.0635	24.3	.0790
30.4	.0637	24.2	.0793
30.3	.0639	24.1	.0797
30.2	.0641	24.0	.0800
30.1	.0643	23.9	.0803
30.0	.0645	23.8	.0806
29.9	.0647	23.7	.0809
29.8	.0649	23.6	.0813
29.7	.0651	23.5	.0816
29.6	.0653	23.4	.0819
29.5	.0656	23.3	.0823
29.4	.0658	23.2	.0826
29.3	.0660	23.1	.0830

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent
23.0	0.0833	16.8	0.1123
22.9	.0837	16.7	.1129
22.8	.0840	16.6	.1135
22.7	.0844	16.5	.1142
22.6	.0847	16.4	.1148
22.5	.0851	16.3	.1155
22.4	.0854	16.2	.1162
22.3	.0858	16.1	.1169
22.2	.0862	16.0	.1176
22.1	.0866	15.9	.1183
22.0	.0870	15.8	.1190
21.9	.0873	15.7	.1197
21.8	.0877	15.6	.1204
21.7	.0881	15.5	.1211
21.6	.0885	15.4	.1218
21.5	.0888	15.3	.1226
21.4	.0892	15.2	.1234
21.3	.0896	15.1	.1242
21.2	.0901	15.0	.1250
21.1	.0905	14.9	.1257
21.0	.0909	14.8	.1265
20.9	.0913	14.7	.1273
20.8	.0917	14.6	.1281
20.7	.0921	14.5	.1289
20.6	.0925	14.4	.1297
20.5	.0930	14.3	.1306
20.4	.0934	14.2	.1315
20.3	.0939	14.1	.1324
20.2	.0943	14.0	.1333
20.1	.0948	13.9	.1342
20.0	.0952	13.8	.1350
19.9	.0957	13.7	.1359
19.8	.0961	13.6	.1368
19.7	.0966	13.5	.1378
19.6	.0970	13.4	.1387
19.5	.0975	13.3	.1397
19.4	.0980	13.2	.1407
19.3	.0985	13.1	.1418
19.2	.0990	13.0	.1429
19.1	.0995	12.9	.1438
19.0	.1000	12.8	.1448
18.9	.1005	12.7	.1458
18.8	.1010	12.6	.1469
18.7	.1015	12.5	.1479
18.6	.1020	12.4	.1490
18.5	.1025	12.3	.1502
18.4	.1030	12.2	.1514
18.3	.1036	12.1	.1526
18.2	.1041	12.0	.1538
18.1	.1047	11.9	.1549
18.0	.1053	11.8	.1561
17.9	.1058	11.7	.1573
17.8	.1063	11.6	.1585
17.7	.1069	11.5	.1597
17.6	.1074	11.4	.1610
17.5	.1080	11.3	.1624
17.4	.1086	11.2	.1637
17.3	.1092	11.1	.1652
17.2	.1098	11.0	.1667
17.1	.1105	10.9	.1680
17.0	.1111	10.8	.1693
16.9	.1117		

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent	Remaining life (years)	Decimal equivalent
10.7	0.1707	5.8	0.2929
10.6	.1721	5.7	.2969
10.5	.1736	5.6	.3011
10.4	.1751	5.5	.3056
10.3	.1767	5.4	.3103
10.2	.1783	5.3	.3155
10.1	.1800	5.2	.3210
10.0	.1818	5.1	.3269
9.9	.1833	5.0	.3333
9.8	.1849	4.9	.3379
9.7	.1865	4.8	.3429
9.6	.1882	4.7	.3481
9.5	.1900	4.6	.3538
9.4	.1918	4.5	.3600
9.3	.1938	4.4	.3667
9.2	.1957	4.3	.3739
9.1	.1978	4.2	.3818
9.0	.2000	4.1	.3905
8.9	.2018	4.0	.4000
8.8	.2037	3.9	.4063
8.7	.2057	3.8	.4130
8.6	.2077	3.7	.4205
8.5	.2099	3.6	.4286
8.4	.2121	3.5	.4375
8.3	.2145	3.4	.4474
8.2	.2169	3.3	.4583
8.1	.2195	3.2	.4706
8.0	.2222	3.1	.4844
7.9	.2244	3.0	.5000
7.8	.2267	2.9	.5088
7.7	.2292	2.8	.5185
7.6	.2317	2.7	.5294
7.5	.2344	2.6	.5417
7.4	.2372	2.5	.5556
7.3	.2401	2.4	.5714
7.2	.2432	2.3	.5897
7.1	.2465	2.2	.6111
7.0	.2500	2.1	.6364
6.9	.2537	2.0	.6667
6.8	.2556	1.9	.6786
6.7	.2587	1.8	.6923
6.6	.2619	1.7	.7083
6.5	.2653	1.6	.7273
6.4	.2689	1.5	.7500
6.3	.2727	1.4	.7778
6.2	.2768	1.3	.8125
6.1	.2811	1.2	.8571
6.0	.2857	1.1	.9167
5.9	.2892	1.0	1.0000

NOTE: For determination of decimal equivalents of remaining lives falling between those shown in the above table, the taxpayer may use the next longest life shown in the table, interpolate from the table, or use the following formula from which the table was derived.

$$D=\frac{2R}{(W+2F)(W+1)}$$

where:

D = Decimal equivalent.
R = Remaining life.
W = Whole number of years in remaining life.
F = Fractional part of year in remaining life.

If the taxpayer desires to carry his calculations of decimal equivalents to a greater number of decimal places than is provided in the table, he may use the formula. The procedure adopted must be consistently followed thereafter.

(b) *Applied to group, classified, or composite accounts*—(1) *General rule.* The sum of the years-digits method may be applied to group, classified, or composite accounts in accordance with the plan described in subparagraph (2) of this paragraph or in accordance with other plans as explained in subparagraph (3) of this paragraph.

(2) *Remaining life plan.* The remaining life plan as applied to a single asset is described in paragraph (a) (2) of § 1.167 (b)–3. This plan may also be applied to group, classified, or composite accounts. Under this plan the allowance for depreciation is computed by applying changing fractions to the unrecovered cost or other basis of the account reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the account (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the years digits corresponding to the years of estimated remaining useful life of the account. Decimal equivalents of such fractions can be obtained by use of Table I under paragraph (a) (2) (ii) of § 1.167 (b)–3. The proper application of this method requires that the estimated remaining useful life of the account be determined each year. This determination, of course, may be made each year by analysis, i. e., by determining the remaining lives for each of the components in the account, and averaging them. The estimated remaining life of any account, however, may also be determined arithmetically. For example, it may be computed by dividing the unrecovered cost or other basis of the account, as computed by straight line depreciation, by the gross cost or other basis of the account, and multiplying the result by the average life of the assets in the account.

of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

(2) Acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

§ 1.167(c)–1 Limitations on methods of computing depreciation under section 167 (b) (2), (3), and (4).

(a) *In general.* (1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167 (b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953 including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For purposes of this section, construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection, the original use of such property commences with the taxpayer and commences after such date.

Sec. 167. *Depreciation.* • • •

(c) *Limitations on use of certain methods and rates.* Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

(1) The construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

(2) Acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

§ 1.167(c)–1 Limitations on methods of computing depreciation under section 167 (b) (2), (3), and (4).

(a) *In general.* (1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167 (b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953 including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For purposes of this section,

the purpose of the preceding sentence, property shall be deemed to be acquired when reduced to physical possession, or control. The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired after December 31, 1953, will not be treated as being put to original use by the taxpayer even though it is put to a different use, nor will a horse acquired for breeding purposes be treated as being put to original use by the taxpayer if prior to the purchase the horse was used for racing purposes. See §§ 1.167 (b)–2, 1.167 (b)–3, and 1.167 (b)–4 for application of the various methods.

(3) Assets having an estimated average useful life of less than three years shall not be included in a group, classified, or composite account to which the methods described in §§ 1.167 (b)–2, 1.167 (b)–3, and 1.167 (b)–4 are applicable. However, an incidental retirement of an asset from such an account prior to the expiration of a useful life of three years will not prevent the application of these methods to such an account.

(4) See section 381 (c) (6) and the regulations thereunder for rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions.

(5) See section 1502 and § 1.1502–46 for regulations covering depreciation of property received by a member of an affiliated group from another member of the group during a consolidated return period.

(6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§ 1.167 (b)–2, 1.167 (b)–3, and 1.167 (b)–4 are not applicable to property in the hands of a distributee, vendee, transferee, donee, or grantee unless the original use of the property begins with such person and the conditions required by section 167 (c) and this section are otherwise met. For example, these methods of depreciation may not be used by a corporation with respect to property which it acquires from an individual or partnership in exchange for its stock. Similarly, if an individual or partnership receives property in a distribution upon dissolution of a corporation, these methods of depreciation may not be used with respect to property so acquired by such individual or partnership. As a further example, these methods of depreciation may not be used by a partnership with respect to contributed property, nor by a partner with respect to partnership property distributed to him. Moreover, where a partnership is entitled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase, and (ii) in the case of a decrease in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

(b) *Illustrations.* (1) The application of these methods to property constructed, reconstructed, or erected by the taxpayer after December 31, 1953, may be illustrated by the following examples:

Example (1). If a building with a total cost of $100,000 is completed after December 31, 1953, and the portion attributable to construction after December 31, 1953, is determined by engineering estimates or by cost accounting records to be $30,000, the methods referred to in paragraph (a) (1) of this section are applicable only to the $30,000 portion of the total.

Example (2). In 1954, a taxpayer has an old machine with an unrecovered cost of $1,000. If he contracts to have it reconditioned, or reconditions it himself, at a cost of an additional $5,000, only the $5,000 may be depreciated under the methods referred to in paragraph (a) (1) of this section, whether or not the materials used for reconditioning are new in use.

Example (3). A taxpayer who acquired a building in 1940 makes major maintenance or repair expenditures in 1954 of a type which must be capitalized. For these expenditures the taxpayer may use a method of depreciation different from that used on the building (for example, the methods referred to in paragraph (a) (1) of this section) only if he accounts for such expenditures separately from the account which contained the original building. In such case, the unadjusted basis on any parts replaced shall be removed from the asset account and shall be charged to the appropriate depreciation reserve account. In the alternative he may capitalize such expenditures by charging them to the depreciation reserve account for the building.

(2) The application of these methods to property which was not constructed, reconstructed, or erected by the taxpayer but which was acquired after December 31, 1953, may be illustrated by the following examples:

Example (1). A taxpayer contracted in 1953 to purchase a new machine which he acquired in 1954 and put into first use in that year. He may use the methods referred to in paragraph (a) (1) of this section, in recovering the cost of the new machine.

Example (2). A taxpayer instead of reconditioning his old machine buys a "factory reconditioned" machine in 1954 to replace it. He cannot apply the methods referred to in paragraph (a) (1) of this section, to any part of the cost of the reconditioned machine since he is not the first user of the machine.

Example (3). In 1954, a taxpayer buys a house for $20,000 which had been used as a personal residence and thus had not been subject to depreciation allowances. He makes a capital addition of $5,000 and rents the property to another. The taxpayer may use the methods referred to in paragraph (a) (1) of this section, only with respect to the $5,000 cost of the addition.

(c) *Election to use methods.* Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167 (b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) of this section, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167 (b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

§ 1.167(d) Statutory provisions; depreciation; agreement as to useful life on which depreciation rate is based.

SEC. 167. *Depreciation.* • • •

(d) *Agreement as to useful life on which depreciation rate is based.* Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of this title, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agreement shall not be effective for taxable years before the taxable year in which notice in writing by certified mail or registered mail is served by the party to the agreement initiating such change.

[Sec. 167(d) as amended by sec. 89(b), Technical Amendments Act 1958 (72 Stat. 1665)]

§ 1.167(d)–1 Agreement as to useful life and rates of depreciation.

After August 16, 1954, a taxpayer may, for taxable years ending after December 31, 1953, enter into an agreement with respect to the estimated useful life, method and rate of depreciation and treatment of salvage of any property which is subject to the allowance for depreciation. An application for such agreement may be made to the district director for the internal revenue district in which the taxpayer's return is required to be filed. Such application shall be filed in quadruplicate and shall contain in such detail as may be practical the following information:

(a) The character and location of the property.

(b) The original cost or other basis and date of acquisition.

(c) Proper adjustments to the basis including depreciation accumulated to the first taxable year to be covered by the agreement.

(d) Estimated useful life and estimated salvage value.

(e) Method and rate of depreciation.

(f) Any other facts and circumstances pertinent to making a reasonable estimate of the useful life of the property and its salvage value.

The agreement must be in writing and must be signed by the taxpayer and by

the district director. The agreement must be signed in quadruplicate, and two of the signed copies will be returned to the taxpayer. The agreement shall set forth its effective date, the estimated remaining useful life, the estimated salvage value, and rate and method of depreciation of the property and the facts and circumstances taken into consideration in adoption of the agreement, and shall relate only to depreciation allowances for such property on and after the effective date of the agreement. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. Any change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life and rate, is sent by the party proposing the change to the other party and is sent by registered mail, if such notice is mailed before September 3, 1958, or is sent by certified mail or registered mail, if such notice is mailed after September 2, 1958. A copy of the agreement (and any modification thereof) shall be filed with the taxpayer's return for the first taxable year which is affected by the agreement (or any modification thereof). A signed copy should be retained with the permanent records of the taxpayer. For rules relating to changes in method of depreciation, see § 1.167 (e)–1 and section 446 and the regulations thereunder.

§ 1.167(e) Statutory provisions; depreciation; change in method.

SEC. 167. *Depreciation.* • • •

(e) *Change in method.* In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b) (2) to the method described in subsection (b) (1).

§ 1.167(e)–1 Change in method.

(a) *In general.* Any change in the method of computing the depreciation allowances with respect to a particular account is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that the change from the declining balance method to the straight line method as provided in section 167(e) shall be permitted without consent. See paragraph (b) of this section. A change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in § 1.167(a)–7. Any change in the percentage of the current straight line rate under the declining balance method, as for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method will constitute a change in method of depreciation and will require the consent of the Commissioner. Any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations thereunder and shall state the character and location of the property, method of depreciation being used and the method proposed, the date of acquisition, the cost or other basis and adjustments thereto, amounts recovered through depreciation and other allowances, the estimated salvage value, the estimated remaining life of the property, and such other information as may be required. For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381 (c) (6) and the regulations thereunder.

(b) *Declining balance to straight line.* In the case of an account to which the method described in section 167 (b) (2) is applicable, a taxpayer may change without the consent of the Commissioner, from the declining balance method of depreciation to the straight line method at any time during the useful life of the property under the following conditions. Such a change may not be made if a provision prohibiting such a change is contained in an agreement under section 167 (d). When the change is made, the unrecovered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. With respect to any account, this change will be permitted only if applied to all the assets in the account as defined in § 1.167 (a)–7. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the remaining useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. A change to the straight line method must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

§ 1.167(f) Statutory provisions; depreciation; basis for depreciation.

SEC. 167. *Depreciation.* • • •

(f) *Basis for depreciation.* The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

§ 1.167(f)–1 Basis for depreciation.

The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

§ 1.167(g) Statutory provisions; depreciation; life tenants and beneficiaries of trusts and estates.

SEC. 167. *Depreciation.* • • •

(g) *Life tenants and beneficiaries of trusts and estates.* In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

§ 1.167(g)–1 Life tenants and beneficiaries of trusts and estates.

(a) *Life tenants.* In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(b) *Trusts.* If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives

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any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

(c) *Estates.* In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate which is allocable to each.

§ 1.167(h) Statutory provisions; depreciation; depreciation of improvements in the case of mines, etc.

SEC. 167. *Depreciation.* • • •

(h) *Depreciation of improvements in the case of mines, etc.* For additional rule applicable to depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber, see section 611.

§ 1.167(h)–1 Depreciation of improvements in the case of mines, etc.

Property used in the trade or business or held for the production of income which is subject to the allowance for depreciation provided in section 611 shall be treated for all purposes of the Code as if it were property subject to the allowance for depreciation under section 167. The preceding sentence shall not limit the allowance for depreciation otherwise allowable under section 611.

§ 1.168 Statutory provisions; amortization of emergency facilities.

SEC. 168. *Amortization of emergency facilities*—(a) *General rule.* Every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any emergency facility (as defined in subsection (d)), based on a period of 60 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be comuputed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall, except to the extent provided in subsection (f), be in lieu of the depreciation deduction with respect to such facility for such month provided by section 167. The 60-month period shall begin as to any emergency facility, at the election of the taxpayer, with the month following the month in which the facility was completed or acquired, or with the succeeding taxable year.

(b) *Election of amortization.* The election of the taxpayer to take the amortization deduction and to begin the 60-month period with the month following the month in which the facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by filing with the Secretary or his delegate, in such manner, in such form, and within such time, as the Secretary or his delegate may by regulations prescribe, a statement of such election.

(c) *Termination of amortization deduction.* A taxpayer which has elected under subsection (b) to take the amortization deduction provided in subsection (a) may, at any time after making such election, discontinue the amortization deduction with respect to the remainder of the amortization period, such discontinuance to begin as of the beginning of any month specified by the taxpayer in a notice in writing filed with the Secretary or his delegate before the beginning of such month. The depreciation deduction provided under section 167 shall be allowed, beginning with the first month as to which the amortization deduction does not apply, and the taxpayer shall not be entitled to any further amortization deduction with respect to such emergency facility.

(d) *Definitions*—(1) *Emergency facility.* For purposes of this section, the term "emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof, the construction, reconstruction, erection, installation, or acquisition of which was completed after December 31, 1949, and with respect to which a certificate under subsection (e) has been made. In no event shall an amortization deduction be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof under this paragraph shall have been made before the filing of the taxpayer's return for such taxable year.

(2) *Emergency period.* For purposes of this section, the term "emergency period" means the period beginning January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the emergency facilities with respect to which certifications under subsection (e) have been made is no longer required in the interest of national defense.

(e) *Determination of adjusted basis of emergency facility.* In determining, for purposes of subsection (a) or (g), the adjusted basis of an emergency facility—

(1) *Certifications on or before August 22, 1957.* In the case of a certificate made on or before August 22, 1957, there shall be included only so much of the amount of the adjusted basis of such facility (computed without regard to this section) as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1949, as the certifying authority, designated by the President by Executive Order, has certified as necessary in the interest of national defense during the emergency period, and only such portion of such amount as such authority has certified as attributable to defense purposes. Such certification shall be under such regulations as may be prescribed from time to time by such certifying authority with the approval of the President. An application for a certificate must be filed at such time and in such manner as may be prescribed by such certifying authority under such regulations, but in no event shall such certificate have any effect unless an application therefor is filed before March 24, 1951, or before the expiration of 6 months after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition, whichever is later.

(2) *Certifications after August 22, 1957.* In the case of a certificate made after August 22, 1957, there shall be included only so much of the amount of the adjusted basis of such facility (computed without regard to this section) as is properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1949, as the certifying authority designated by the President by Executive order, has certified is to be used—

(A) To produce new or specialized defense items or components of new or specialized defense items (as defined in paragraph (4)) during the emergency period,

(B) To provide research, developmental, or experimental services during the emergency period for the Department of Defense (or one of the component departments of such Department), or for the Atomic Energy Commission, as a part of the national defense program, or

(C) To provide primary processing for uranium ore or uranium concentrate under a program of the Atomic Energy Commission for the development of new sources of uranium ore or uranium concentrate,

and only such portion of such amount as such authority has certified is attributable to the national defense program. Such certification shall be under such regulations as may be prescribed from time to time by such certifying authority with the approval of the President. An application for a certificate must be filed at such time and in such manner as may be prescribed by such certifying authority under such regulations but in no event shall such certificate have any effect unless an application therefor is filed before the expiration of 6 months after the beginning of such construction, reconstruction, erection, or installation or the date of such acquisition. For purposes of the preceding sentence, an application which was timely filed under this subsection on or before August 22, 1957, and which was pending on such date, shall be considered to be an application timely filed under this paragraph.

(3) *Separate facilities; special rule.* After the completion or acquisition of any emergency facility with respect to which a certificate under paragraph (1) or (2) has been made, any expenditure (attributable to such facility and to the period after such completion or acquisition) which does not represent construction, reconstruction, erection, installation, or acquisition included in such certificate, but with respect to which a separate certificate is made under paragraph (1) or (2), shall not be applied in adjustment of the basis of such facility, but a separate basis shall be computed therefor pursuant to paragraph (1) or (2), as the case may be, as if it were a new and separate emergency facility.

(4) *Definitions.* For purposes of paragraph (2)—

(A) *New or specialized defense item.* The term "new or specialized defense item" means only an item (excluding services)—

(i) Which is produced, or will be produced, for sale to the Department of Defense (or one of the component departments of such Department), or to the Atomic Energy Commission, for use in the national defense program, and

(ii) For the production of which existing productive facilities are unsuitable because of its newness or of its specialized defense features.

(B) *Component of new or specialized defense item.* The term "component of a new or specialized defense item" means only an item—

(i) Which is, or will become, a physical part of a new or specialized defense item, and

(ii) For the production of which existing productive facilities are unsuitable because of its newness or of its specialized defense features.

(5) *Limitation with respect to uranium ore or uranium concentrate processing facilities.* No certificate shall be made under paragraph (2)(C) with respect to any facility unless existing facilities for processing the uranium ore or uranium concentrate which will be processed by such facility are unsuitable because of their location.

(f) *Depreciation deduction.* If the adjusted basis of the emergency facility (computed without regard to this section) is in excess of the adjusted basis computed under subsection (e), the depreciation deduction provided by section 167 shall despite the provisions of subsection (a) of this section, be allowed with respect to such emergency facility as if its adjusted basis for the purpose of such deduction were an amount equal to the amount of such excess.

(g) *Payment by United States of unamortized cost of facility.* If an amount is properly includible in the gross income of the taxpayer on account of a payment with re-

spect to an emergency facility and such payment is certified as provided in paragraph (1), then, at the election of the taxpayer in its return for the taxable year in which such amount is so includible—

(1) The amortization deduction for the month in which such amount is so includible shall (in lieu of the amount of the deduction for such month computed under subsection (a)) be equal to the amount so includible but not in excess of the adjusted basis of the emergency facility as of the end of such month (computed without regard to any amortization deduction for such month). Payments referred to in this subsection shall be payments the amounts of which are certified, under such regulations as the President may prescribe, by the certifying authority designated by the President as compensation to the taxpayer for the unamortized cost of the emergency facility made because—

(A) A contract with the United States involving the use of the facility has been terminated by its terms or by cancellation, or

(B) The taxpayer had reasonable ground (either from provisions of a contract with the United States involving the use of the facility, or from written or oral representations made under authority of the United States) for anticipating future contracts involving the use of the facility, which future contracts have not been made.

(2) In case the taxpayer is not entitled to any amortization deduction with respect to the emergency facility, the depreciation deduction allowable under section 167 on account of the month in which such amount is so includible shall be increased by such amount, but such deduction on account of such month shall not be in excess of the adjusted basis of the emergency facility as of the end of such month (computed without regard to any amount allowable, on account of such month, under section 167 or this paragraph).

(h) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant.

(i) *Termination.* No certificate under subsection (e) shall be made with respect to any emergency facility after December 31, 1959.

(j) *Cross reference.* For special rule with respect to gain derived from the sale or exchange of property the adjusted basis of which is determined with regard to this section, see section 1238.

[Sec. 168 as amended by sec. 4, Act of Aug. 26, 1957 (Pub. Law 85–165, 71 Stat. 414); sec. 9, Technical Amendments Act 1958 (72 Stat. 1608)]

§ 1.168–1 Amortization of emergency facilities; general rule.

(a) A person (including an estate or trust (see section 642(f) and § 1.642(f)–1) and a partnership (see section 703 and § 1.703–1)) is entitled, by election, to a deduction with respect to the amortization of the adjusted basis (for determining gain) of an emergency facility, such amortization to be based on a period of 60 months. As to the adjusted basis of an emergency facility, see § 1.168–5. The taxpayer may elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed or acquired, or (2) the taxable year succeeding that in which such facility was completed or acquired (see § 1.168–2). The date on which, or the month within which, an emergency facility is completed or acquired is to be determined upon the facts in the particular case. Ordinarily, the taxpayer is in possession of all the facts and, therefore, in a position to ascertain such date. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility.

(b) Generally, an amortization deduction will not be allowed with respect to an emergency facility for any taxable year unless such facility has been certified before the date of filing of the taxpayer's income tax return for such taxable year. However, this limitation does not apply in the case of a certificate made after August 22, 1957, for an emergency facility to provide primary processing for uranium ore or uranium concentrate under a program of the Atomic Energy Commission for the development of any sources of uranium ore or uranium concentrate, if application for such certificate was filed either (1) before September 2, 1958, and before the expiration of six months after the beginning of construction, reconstruction, erection, or installation or the date of acquisition of the facility, or (2) after September 1, 1958, and on or before December 2, 1958.

(c) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of each month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. The adjusted basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to an emergency facility for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. The amortization deduction taken for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 167. See, however, § 1.168–6, relating to depreciation with respect to any portion of the emergency facility not subject to amortization.

(d) This section may be illustrated by the following examples:

Example (1). On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, begins the construction of an emergency facility which is completed on September 30, 1954, at a cost of $240,000. The certificate covers the entire construction. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with October, the month following its completion. The adjusted basis of the facility at the end of October is $240,000. The allowable amortization deduction with respect to such facility for the taxable year 1954 is $12,000, computed as follows:

Monthly amortization deductions:	
October: $240,000 divided by 60	$4,000
November: $236,000 ($240,000 minus $4,000) divided by 59	4,000
December: $232,000 ($236,000 minus $4,000) divided by 58	4,000
Total amortization deduction for 1954	12,000

Example (2). The Y Corporation, which makes its income tax returns on the basis of a fiscal year ending November 30, purchases an emergency facility (No. 1) on July 29, 1955. On June 15, 1955, it begins the construction of an emergency facility (No. 2) which is completed on August 2, 1955. The entire acquisition and construction of such facilities are covered by the certificate. The Y Corporation elects to take amortization deductions with respect to both facilities and to begin the 60-month amortization period in each case with the month following the month of acquisition or completion. At the end of the first month of the amortization period the adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000. In September 1955, facility No. 1 is damaged by fire, as a result of which its adjusted basis is properly reduced by $25,370. The allowable amortization deduction with respect to such facilities for the taxable year ending November 30, 1955, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:	
August: $300,000 divided by 60	$5,000
September: $269,630 ($300,000 minus $5,000 and $25,370) divided by 59	4,570
October: $265,060 ($269,630 minus $4,570) divided by 58	4,570
November: $260,490 ($265,060 minus $4,570) divided by 57	4,570
Amortization deduction for 1955	18,710

Facility No. 2

Monthly amortization deductions:	
September: $54,000 divided by 60	$900
October: $53,100 divided by 59	900
November: $52,200 divided by 58	900
Amortization deduction for 1955	2,700
Total amortization deduction for 1955	21,410

Example (3). On June 15, 1954, the Z Corporation, which makes its income tax returns on the calendar year basis, completes the construction of an emergency facility at a cost of $110,000. In its income tax return for 1954, filed on March 15, 1955, the Z Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, the month following its completion. No certificate with respect to such facility is made until April 10, 1955, and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1954. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1954, such deduction being assumed, for the purposes of this example, to be $2,000. Accordingly, the adjusted basis of such facility at the end of January 1955 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1955, the Z Corporation is, with respect to such facility, entitled to an amortization deduction of $24,000, computed as follows:

Monthly amortization deductions:	
January: $108,000 divided by 54	$2,000
February: $106,000 ($108,000 minus $2,000) divided by 53	2,000
March: $104,000 ($106,000 minus $2,000) divided by 52	2,000

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For the remaining nine months (similarly computed)	$18,000
Total amortization deduction for 1955	24,000

Since the Z Corporation elected in its return for 1954 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, it must compute its amortization deductions for the 12 months in the taxable year 1955 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

§ 1.168–2 Election of amortization.

(a) *General rule.* An election by the taxpayer to take amortization deductions with respect to an emergency facility and to begin the 60-month amortization period either with the month following the month in which such facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by a statement to that effect in its return for the taxable year in which falls the first month of the 60-month amortization period so elected. However, if the facility is described in section 168(e)(2)(C) and an application for a certificate is filed within the period prescribed by section 9(c) of the Technical Amendments Act of 1958 (72 Stat. 1609) and paragraph (b) of § 1.168–1, the election may be made by a statement in an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. The statement and amended return in such case must be filed not later than 90 days after the date the certificate is made or not later than April 4, 1960, whichever is later. Amended income tax returns or claims for credit or refund should also be filed for other taxable years which are within such amortization period and which precede the taxable year in which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(b) *Election not made in prescribed manner.* If the statement of election is not made by the taxpayer as prescribed in paragraph (a) of this section, it may, in the discretion of the Commissioner and for good cause shown, be made in such manner and form and within such time as may be approved by the Commissioner

(c) *Other requirements and considerations.* No method of making such election other than those prescribed in this section and corresponding sections of prior regualtions is permitted. Any statement of election should contain a description clearly identifying each emergency facility for which an amortization deduction is claimed. A taxpayer which does not elect, in the manner prescribed in this section or corresponding sections of prior regulations, to take amortization deductions with respect to an emergency facility shall not be entitled to such deductions.

§ 1.168–3 Election to discontinue amortization.

(a) If a taxpayer has elected to take amortization deductions with respect to an emergency facility, it may, after such election and prior to the expiration of the 60-month amortization period, discontinue the amortization deductions for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by a notice in writing filed with the district director for the internal revenue district in which the return of the taxpayer is required to be filed, specifying the month as of the beginning of which the taxpayer elects to discontinue such deductions. Such notice shall be filed before the beginning of the month specified therein, and shall contain a description clearly identifying the emergency facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer so elects to discontinue the amortization deductions, it shall not be entitled to any further amortization deductions with respect to such facility.

(b) A taxpayer which thus elects to discontinue amortization deductions with respect to an emergency facility is entitled, if such facility is depreciable property under section 167 and the regulations thereunder, to a deduction for depreciation with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable, and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder).

(c) This section may be illustrated by the following example:

Example. On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, purchases an emergency facility, consisting of land with a building thereon, at a cost of $306,000 of which $60,000 is allocable to the land and $246,000 to the building. The certificate covers the entire acquisition. The corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with the taxable year 1955. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1954. On March 25, 1956, the corporation files notice with the district director of its election to discontinue the amortization deductions beginning with the month of April 1956. The adjusted basis of the facility on January 31, 1955, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1954 ($6,000). The amortization deductions for the taxable year 1955 and the months of January, February, and March 1956, amount to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1955), the adjusted basis of the land ($60,000) is one-fifth of the adjusted basis of the entire facility ($300,000) and since there are no adjustments to basis other than on account of amortization during the period, the adjusted basis of the land should be reduced by $15,000, or one-fifth of the entire amortization deduction, and the adjusted basis of the building should be reduced by $60,000, or four-fifths of the entire amortization deduction. Accordingly, the adjusted basis of the facility as of April 1, 1956, is $225,000, of which $180,000 is allocable to the building for the purpose of depreciation deductions under section 167, and $45,000 is allocable to the land.

§ 1.168–4 Definitions.

As used in the regulations under section 168, the term—

(a) "Certifying authority" means the certifying authority designated by the President by Executive order.

(b) "Emergency facility" means any facility, land, building, machinery, or equipment, or any part thereof, the acquisition of which occurred after December 31, 1949, or the construction, reconstruction, erection, or installation of which was completed after such date, and with respect to which a certificate under section 168 (e) has been made. In the case of an application for a certificate under section 168 (e) which is filed after March 23, 1951, only the part of any such facility which is constructed, reconstructed, erected, or installed by any person not earlier than six months prior to the filing of such application, and which is certified in accordance with section 168 (e), shall be deemed to be an emergency facility, notwithstanding that the other part of such facility was constructed, reconstructed, erected, or installed earlier than six months prior to the filing of such application. However, if the facility is one described in section 168(e)(2)(C) and the application was filed after September 1, 1958, and on or before December 2, 1958, the preceding sentence shall not apply. The term "emergency facility," as so defined, may include, among other things, improvements of land, such as the construction of roads, bridges, and airstrips, and the dredging of channels.

(c) "Emergency period" means the period beginning on January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the certified emergency facilities is no longer required in the interest of national defense.

§ 1.168–5 Adjusted basis of emergency facility.

(a) *In general.* (1) The adjusted basis of an emergency facility for the purpose of computing the amortization deduction may differ from what would otherwise constitute the adjusted basis of such emergency facility in that it shall be the adjusted basis for determining gain (see part II (section 1011 and following), subchapter 0, chapter 1 of the Code) and in that it may be only a portion of what would otherwise constitute the adjusted basis. It will be only a portion of such other adjusted basis if only a portion of the basis (unadjusted) is attributable to certified construction, reconstruction, erection, installation, or acquisition taking place after December 31, 1949. Also, it will be only a portion of what would otherwise constitute the adjusted basis of the emergency facility if only a portion of the basis (unadjusted) is certified as attributable to defense purposes or, in the case of a certification after August 22, 1957, if only a portion of the basis (unadjusted) is certified as attributable to the national defense program. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

(2) The unadjusted basis for amortization purposes is the same as the unadjusted basis otherwise determined only when the entire construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and is certified in its entirety by the certifying authority.

(3) In cases in which only a portion of the construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and that portion is certified in its entirety by the certifying authority, the unadjusted basis for the purpose of amortization is so much of the entire unadjusted basis as is attributable to the certified construction, reconstruction, erection, installation, or acquisition which takes place after December 31, 1949. For example, the X Corporation begins the construction of a facility on November 15, 1949, and such facility is completed on April 1, 1952, at a cost of $5,000,000, of which $4,600,000 is attributable to construction after December 31, 1949. The entire construction after December 31, 1949, is certified by the certifying authority. The unadjusted basis of the emergency facility for amortization purposes is therefore $4,600,000. For depreciation of the remaining portion ($400,000) of the cost see § 1.168–6.

(4) If the certifying authority certifies only a portion of the construction, reconstruction, erection, installation, or acquisition of property which takes place after December 31, 1949, the unadjusted basis for amortization purposes is limited to such portion so certified. Assuming the same facts as in the example in subparagraph (3) of this paragraph, except that only 50 percent of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, is certified, the unadjusted basis for amortization purposes is 50 percent of $4,600,000, or $2,300,000.

(5) The adjusted basis of an emergency facility for amortization purposes is the unadjusted basis for amortization purposes less the adjustments properly applicable thereto. Such adjustments are those specified in sections 1016 and 1017, except that no adjustments are to be taken into account which increase the adjusted basis. (See paragraph (b) of this section.) If the taxpayer constructs, reconstructs, erects, installs, or acquires an emergency facility pursuant to a cost reimbursement contract with an obligation for reimbursement by the United States of all or a part of the cost of such facility, the unadjusted basis of such facility for amortization purposes shall not include that part of the cost for which the taxpayer is entitled to reimbursement, and the amount received as reimbursement shall be treated as a capital receipt. However, amounts received by a taxpayer which represent in fact compensation by reason of termination of a government contract or payment for articles under such a contract, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility.

(6) The following examples will illustrate the computation of the adjusted basis of an emergency facility for amortization purposes:

Example (1). The X Corporation completes an emergency facility on July 1, 1954, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for the purpose of amortization is $300,000. The X Corporation elects to begin amortization as of January 1, 1955. The only adjustment to basis for the period July 1, 1954, to January 31, 1955, other than depreciation or amortization for January 1955, is $5,000 for depreciation for the last six months of 1954. The adjusted basis for the purpose of amortization is therefore $300,000 less $3,000 (300,000/500,000 × $5,000), or $297,000.

Example (2). On July 31, 1956, the Y Corporation has an emergency facility (a building) which was completed on July 1, 1952, the entire basis of which is $500,000 and the unadjusted basis of which for the purpose of amortization is $300,000. The corporation elected to begin amortization as of January 1, 1953, at which time it was entitled to $5,000 depreciation for the last six months of 1952. On July 1, 1956, the facility was damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted basis of the emergency facility as of July 1956 for the purpose of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100.00, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to Jan. 1, 1953	3,000.00	2,000.00	5,000
Adjusted basis January 1953	297,000.00	198,000.00	495,000
Less amortization for 42 months	207,000.00		207,900
Less depreciation for 42 months		14,000.00	14,000
Adjusted basis at time of fire	89,100.00	184,000.00	273,100
Less fire loss (apportioned as explained below)	65,250.82	134,749.18	200,000
Adjusted basis after fire loss	23,849.18	49,250.82	73,100

The $200,000 fire loss is applied against the adjusted basis for the purpose of amortization and the adjusted basis for the purpose of depreciation in the proportion that each such adjusted basis at the time of the fire bears to their sum, i. e., 89,100/273,100 × $200,000 or $65,250.82, against the amortization basis, and 184,000/273,100 × $200,000, or $134,749.18 against the depreciation basis.

(b) *Capital additions.* (1) If, after the completion or acquisition of an emergency facility which has been certified by the certifying authority, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not covered by such certification, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certification. If such further expenditures are separately certified in accordance with the provisions of section 168(e) (1) or (2) and this section, they are treated as certified expenditures in connection with a new and separate emergency facility and, if proper election is made, will be taken into account in computing the adjusted basis of such new and separate emergency facility for the purpose of amortization.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. On March 1, 1954, the certifying authority certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1954. The Z Corporation, on August 1, 1954, begins the installation in the plant of an additional boiler, which is not included in the certification for the plant but is certified as a new and separate emergency facility. For amortization purposes, the adjusted basis of the heating plant is determined without including the cost of the additional boiler. Such cost is taken into account in computing the adjusted basis of the new and separate emergency facility (the boiler), as to which the taxpayer has a separate election for amortization purposes and a separate amortization period.

§ 1.168–6 Depreciation of portion of emergency facility not subject to amortization.

(a) The rule that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable under section 167 is subject to the exception provided in section 168 (f). Under this exception, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder and if the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deductions is in excess of the adjusted basis computed for the purpose of the amortization deductions, then the excess shall be charged off over the useful life of the facility and recovered through depreciation deductions. Thus, if the construction of an emergency facility is begun on or before December 31, 1949, and completed after such date, no amortization deductions are allowable with respect to the amount attributable to such construction on or before such date (see § 1.168–5). However, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the amount attributable to such construction on or before December 31, 1949.

(b) Similarly, if only a portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, of an emergency facility has been certified by the certifying authority, and if such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the portion which has not been so certified.

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(c) For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in paragraph (a) (6) of § 1.168–5.

§ 1.168–7 Payment by United States of unamortized cost of facility.

(a) Section 168(g) contemplates that certain payments may be made by the United States to a taxpayer as compensation for the unamortized cost of an emergency facility. If any such payment is properly includible in gross income and has been certified, as provided in section 168(g), as having been paid under the circumstances described therein, a taxpayer which is recovering the adjusted basis of an emergency facility through amortization rather than depreciation may elect to take an amount equal to such payment as an amortization deduction with respect to such facility for the month in which such payment is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, but it shall not in any case exceed the adjusted basis of such facility (see § 1.168–5) as of the end of such month (computed without regard to any amortization deduction for such month). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(b) If a taxpayer is recovering the adjusted basis of an emergency facility through depreciation rather than amortization, the depreciation deduction allowable under section 167 for the month in which the amount of any such payment is includible in gross income shall, at the taxpayer's election, be increased by such amount; but the total deduction with respect to the certified portion of such facility shall not in any case exceed the adjusted basis of such facility (computed as provided in section 168 (e) and § 1.168–5 for amortization purposes) as of the end of such month (computed without regard to any amount allowable for such month under section 167 or 168 (g) (2)). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(c) This section may be illustrated by the following examples:

Example (1). On January 31, 1954, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate covers the entire acquisition. The X Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with February 1954, the month following the month of acquisition. On July 15, 1955, as a result of the cancellation of certain contracts with the X Corporation, the United States makes a payment of $300,000 to the corporation as compensation for the unamortized cost of such facility. The $300,000 payment is includible in the X Corporation's gross income for July 1955. The adjusted basis of such facility for amortization purposes as of the end of July 1955, computed without regard to any amortization deduction for such month, is $430,000. Accordingly, the corporation is entitled to take an amortization deduction of $300,000 for such month, in lieu of the $10,000 amortization deduction which is otherwise allowable.

Example (2). On November 30, 1954, the Y Corporation purchases an emergency facility, consisting of land with a building thereon, at a cost of $500,000, of which $200,000 is allocable to the land and $300,000 to the building. The certificate covers the entire acquisition. The Y Corporation does not elect to take amortization deductions with respect to such facility, but is entitled to a depreciation deduction with respect to the building at the rate of 3 percent per annum, or $750 per month. On August 12, 1956, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unrecovered cost of such facility'. The $400,000 is includible in the Y Corporation's gross income for August 1956. The adjusted basis of the facility as of the end of August 1956, computed without regard to depreciation for such month, is $485,000, of which amount $200,000 is allocable to the land and $285,000 to the building. Accordingly, the corporation is entitled to increase the $750 depreciation deduction for August 1956 by the full amount of the $400,000 payment.

§ 1.169 Statutory provisions; amortization of grain-storage facilities.

SEC. 169. *Amortization of grain-storage facilities*—(a) *Allowance of deduction*—(1) *Original owner.* Any person who constructs, reconstructs, or erects a grain-storage facility (as defined in subsection (d)) shall, at his election, be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of such facility based on a period of 60 months. The 60-month period shall begin as to any such facility, at the election of the taxpayer, with the month following the month in which the facility was completed, or with the succeeding taxable year.

(2) *Subsequent owners.* Any person who acquires a grain-storage facility from a taxpayer who—

(A) Elected under subsection (b) to take the amortization deduction provided by this subsection with respect to such facility, and

(B) Did not discontinue the amortization deduction pursuant to subsection (c),

shall, at his election, be entitled to a deduction with respect to the adjusted basis (determined under subsection (e) (2)) of such facility based on the period, if any, remaining (at the time of acquisition) in the 60-month period elected under subsection (b) by the person who constructed, reconstructed, or erected such facility.

(3) *Amount of deduction.* The amortization deduction provided in paragraphs (1) and (2) shall be an amount, with respect to each month of the amortization period within the taxable year, equal to the adjusted basis of the facility at the end of such month, divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be computed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall be in lieu of the depreciation deduction with respect to such facility for such month provided by section 167.

(b) *Election of amortization.* The election of the taxpayer under subsection (a) (1) to take the amortization deduction and to begin the 60-month period with the month following the month in which the facility was completed shall be made only by a statement to that effect in the return for the taxable year in which the facility was completed. The election of the taxpayer under subsection (a) (1) to take the amortization deduction and to begin such period with the taxable year succeeding such year shall be made only by a statement to that effect in the return for such succeeding taxable year. The election of the taxpayer under subsection (a) (2) to take the amortization deduction shall be made only by a statement to that effect in the return for the taxable year in which the facility was acquired. Notwithstanding the preceding three sentences, the election of the taxpayer under subsection (a) (1) or (2) may be made, under such regulations as the Secretary or his delegate may prescribe, before the time prescribed in the applicable sentence.

(c) *Termination of amortization deduction.* A taxpayer which has elected under subsection (b) to take the amortization deduction provided in subsection (a) may, at any time after making such election, discontinue the amortization deduction with respect to the remainder of the amortization period, such discontinuance to begin as of the beginning of any month specified by the taxpayer in a notice in writing filed with the Secretary or his delegate before the beginning of such month. The depreciation deduction provided under section 167 shall be allowed, beginning with the first month as to which the amortization deduction does not apply, and the taxpayer shall not be entitled to any further amortization deduction with respect to such facility.

(d) *Definition of grain-storage facility.* For purposes of this section, the term "grain-storage facility" means—

(1) Any corn crib, grain bin, or grain elevator, or any similar structure suitable primarily for the storage of grain, which crib, bin, elevator, or structure is intended by the taxpayer at the time of his election to be used for the storage of grain produced by him (or, if the election is made by a partnership, produced by the members thereof); and

(2) Any public grain warehouse permanently equipped for receiving, elevating, conditioning, and loading out grain,

the construction, reconstruction, or erection of which was completed after December 31, 1952, and on or before December 31, 1956. If any structure described in clause (1) or (2) of the preceding sentence is altered or remodeled so as to increase its capacity for the storage of grain, or if any structure is converted, through alteration or remodeling, into a structure so described, and if such alteration or remodeling was completed after December 31, 1952, and on or before December 31, 1956, such alteration or remodeling shall be treated as the construction of a grain-storage facility. The term "grain-storage facility" shall include only property of a character which is subject to the allowance for depreciation provided in section 167. The term "grain-storage facility" shall not include any facility any part of which is an emergency facility within the meaning of section '38 of this title.

(e) *Determination of adjusted basis*—(1) *Original owners.* For purposes of subsection (a) (1)—

(A) In determining the adjusted basis of any grain-storage facility, the construction, reconstruction, or erection of which was begun before January 1, 1953, there shall be included only so much of the amount of the adjusted basis (computed without regard to this subsection) as is properly attributable to such construction, reconstruction, or erection after December 31, 1952; and

(B) In determining the adjusted basis of any facility which is a grain-storage facility within the meaning of the second sentence of subsection (d), there shall be included only so much of the amount otherwise included in such basis as is properly attributable to the alteration or remodeling.

If any existing grain-storage facility as defined in the first sentence of subsection (d) is altered or remodeled as provided in the second sentence of subsection (d), the ex-

penditures for such remodeling or alteration shall not be applied in adjustment of the basis of such existing facility but a separate basis shall be computed in respect of such facility as if the part altered or remodeled were a new and separate grain-storage facility.

(2) *Subsequent owners.* For purposes of subsection (a) (2), the adjusted basis of any grain-storage facility shall be whichever of the following amounts is the smaller:

(A) The basis (unadjusted) of such facility for purposes of this section in the hands of the transferor, donor, or grantor, adjusted as if such facility in the hands of the taxpayer had a substituted basis within the meaning of section 1016 (b), or

(B) So much of the adjusted basis (for determining gain) of the facility in the hands of the taxpayer (as computed without regard to this subsection) as is properly attributable to construction, reconstruction, or erection after December 31, 1952.

(f) *Depreciation deduction.* If the adjusted basis of the grain-storage facility (computed without regard to subsection (e)) exceeds the adjusted basis computed under subsection (e), the depreciation deduction provided by section 167 shall, despite the provisions of subsection (a) (3) of this section, be allowed with respect to such grain-storage facility as if the adjusted basis for the purpose of such deduction were an amount equal to the amount of such excess.

(g) *Life tenant and remainderman.* In the case of property held by one person for life with remainder to another person, the amortization deduction provided in subsection (a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

§ 1.169–1 General scope of section 169.

(a) Section 169 provides for the amortization of grain-storage facilities, as defined therein, over a period of 60 months. The amortization deduction is allowable at the election of the taxpayer and subject to the provisions of section 169. The amortization deduction is not only allowable to the original owner of a grain-storage facility, but may be allowable to any subsequent owner who acquires the facility from another person who elected to take the amortization deduction and had not discontinued such deduction under the statute. In the case of the original owner of a grain-storage facility the amortization period is 60 months. For a subsequent owner the amortization period is the period, if any, remaining at the time of his acquisition in the 60-month period elected by the person who completed construction, reconstruction, or erection of the grain-storage facility.

(b) Cross-references: For the right of estates and trusts to amortize grain-storage facilities, see section 642 (f) and the regulations thereunder. For the allowance of the amortization deduction in the case of grain-storage facilities of partnerships, see section 703 (b) and the regulations thereunder.

§ 1.169–2 Definition of grain-storage facility.

(a) *General.* For the purpose of section 169 the term "grain-storage facility" means—

(1) Any corn crib, grain bin, or grain elevator, or any similar structure suitable primarily for the storage of grain, but only if the taxpayer at the time of his election to take the amortization deduction allowed under section 169 intends such crib, bin, elevator, or structure to be used for the storage of grain produced by him or, in case the election to take the amortization deduction is made by a partnership, only if such crib, bin, elevator, or structure is intended by the partnership at the time of its election to be used for the storage of grain produced by members of the partnership; and

(2) Any public grain warehouse or elevator permanently equipped for receiving, elevating, conditioning, and loading out grain,

the construction, reconstruction, or erection of which was completed after December 31, 1952, and on or before December 31, 1956. The term "grain" includes all products commonly classed as grain, such as wheat, corn, oats, barley, rye, rice, soybeans, grain sorghums, flaxseed, and dry edible beans.

(b) *Private grain-storage facilities.* In the case of any structure described in paragraph (a) (1) of this section, the construction, reconstruction, or erection of which was completed after December 31, 1952, and on or before December 31, 1956, the taxpayer at the time of his election to take the amortization deduction with respect to the structure must intend to use the facility for the storage of grain produced or to be produced by him. If the election is made by a partnership, the structure must be intended at the time of the election to be used for the storage of grain produced by one or more members of the partnership. The statute does not require that the facility be actually used at the time of the election for the storage of grain. The intent required by the statute at the time of the taxpayer's election to take the amortization deduction is applicable not only to the original owner who completed the construction, reconstruction, or erection of the facility, but to any subsequent owner of the facility. The existence of the requisite intent is a question of fact to be ascertained from the circumstances of each particular case. The lack of the required intent with respect to the use of the facility by a subsequent owner does not affect the allowance of the amortization deduction to a preceding owner for the period during which the facility was owned by him. However, the absence of the required intent as to the use of the facility on the part of either the original owner or any intervening owner precludes any subsequent owner from taking the amortization deduction with respect to the facility. A structure is not suitable primarily for the storage of grain if it is of a type customarily used for other purposes, even though it may actually be used for storing grain. For example, no part of a residential dwelling may qualify as a grain-storage facility. Nor is a structure suitable primarily for the storage of grain unless it is so constructed as to be especially adapted to efficient storage of grain. Thus, a general utility type of building does not qualify under the statute as a grain-storage facility, even though it may be actually used for storing grain. However, structures not suitable primarily for the storage of grain may through alteration or remodeling qualify as grain-storage facilities (see paragraph (d) of this section). On the other hand, a structure which is suitable primarily for the storage of grain is not disqualified under the statute merely because it may at times be used for other purposes. The structures described in paragraph (a) (1) of this section may include trackside grain-storage facilities.

(c) *Public grain-storage facilities.* The term "public grain warehouse" as used in section 169 (d) includes only a grain warehouse or elevator transacting business with members of the general public. The amortization deduction, however, is not available to a person who stores only grain purchased for consumption in his business, such as a milling company which constructs storage facilities for purchased grain held for processing. The statute also requires that the grain warehouse or elevator must be permanently equipped for receiving, elevating, conditioning, and loading out grain. A public grain warehouse must be a permanent structure, of either the elevator or so-called "flat storage" type, suitable primarily for the storage of grain, and the equipment for receiving, elevating, conditioning, or loading out grain must be either permanently installed or permanently available for use. When such equipment is permanently installed, it is considered a part of the grain warehouse or elevator for the purpose of section 169. On the other hand, portable equipment will not be considered a part of the grain warehouse or elevator for such purpose. The term "conditioning" as used in section 169 (d) includes turning, drying, aerating, fumigating, or other processing of grain. While it is not essential for qualification as a grain-storage facility that a public grain warehouse or elevator be permanently equipped to render all services embraced within the meaning of "conditioning", the grain warehouse or elevator must be permanently equipped for turning, drying, or similar processing of grain. The fact that a public grain warehouse accepts for storage, in addition to products commonly classed as grain (see paragraph (a) of this section), other products which are ordinarily stored in grain warehouses does not disqualify the warehouse as a grain-storage facility for the purpose of section 169.

(d) *Alteration or remodeling.* (1) If any structure described in paragraph (a) (1) or (2) of this section is altered or remodeled so that its capacity for the storage of grain is increased, and such alteration or remodeling was completed after December 31, 1952, and on or before December 31, 1956, for the purpose of section 169 such alteration or remodeling is treated as the construction of a grain-storage facility. Such alteration or remodeling may qualify as a grain-storage facility, whether or not the original structure constituted a grain-storage facility as defined in section 169 (d). If the original structure did qualify as a grain-storage facility for the purpose of section 169, the amortization deduction allowable under section 169 (a) may be taken with respect to such alteration or remodeling, whether or not the taxpayer or any preceding owner elected to take the amortization deduction allowable with respect to the original structure.

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(2) Likewise, if any structure not described in paragraph (a) (1) or (2) of this section is converted through alteration or remodeling into a structure so described, and such alteration or remodeling was completed after December 31, 1952, and on or before December 31, 1956, for the purpose of section 169 such alteration or remodeling is treated as the construction of a grain-storage facility.

(3) For election to take the amortization deduction with respect to alteration or remodeling described in subparagraphs (1) and (2) of this paragraph, see § 1.169–4. For determination of adjusted basis for the purpose of the amortization deduction with respect to a grain-storage facility attributable to such alteration or remodeling, see § 1.169–6.

(e) *Excluded property*—(1) *Nondepreciable property.* The term "grain-storage facility" includes only property of a character which is subject to the allowance for depreciation provided in section 167. Thus, "grain-storage facility" does not include the land on which a structure defined in paragraph (a) of this section is erected.

(2) *Emergency facilities.* (i) The term "grain-storage facility" does not include any facility any part of which is considered an emergency facility within the meaning of section 168. For the definition of "emergency facility" for the purpose of section 168, see § 1.168–4.

(ii) If all or any part of the adjusted basis (computed under section 1011) of a structure described in paragraph (a) of this section is certified as an "emergency facility" under section 168 (e), such structure cannot qualify as a "grain-storage facility" for the purposes of section 169. However, if, prior to the making of any election to take the amortization deduction allowable under section 168 (a) with respect to such structure, the certificate made under section 168 (e) is cancelled by the certifying authority, such structure will be considered a "grain-storage facility" for the purposes of section 169.

(iii) In the case of any alteration or remodeling described in paragraph (d) (1) or (2) of this section, if all or any part of the adjusted basis (computed under section 1011) of the original structure is certified as an "emergency facility" under section 168(e), such alteration or remodeling may, nevertheless, qualify as a "grain-storage facility" for the purposes of section 169, provided the following conditions are met:

(*a*) None of the expenditures attributable to such alteration or remodeling represents construction, reconstruction, erection, installation, or acquisition included in the certificate made under section 168(e) with respect to the original structure, and

(*b*) A separate certificate is not made under section 168 (e) with respect to such alteration or remodeling as a new and separate emergency facility, or if a separate certificate was made, such certificate, prior to the making of any election to take the amortization deduction allowable under section 168 (a) with respect to such alteration or remodeling, is canceled by the certifying authority.

§ 1.169–3 Amortization deduction.

(a) *Original owner.* Any person who constructs, reconstructs, or erects a grain-storage facility as defined in section 169 (d) is entitled at his election to a deduction with respect to the amortization of the adjusted basis (for determining gain) of such facility based on a period of 60 months. As to the adjusted basis of a grain-storage facility, see § 1.169–6. The taxpayer may, with respect to a grain-storage facility, elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed, or (2) the first month of the taxable year succeeding that in which such facility was completed (see § 1.169–4). The date on which, or the month within which, a grain-storage facility is completed is to be determined upon the facts in the particular case. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility.

(b) *Subsequent owner.* Any person who acquires a grain-storage facility from a taxpayer who elected to take the amortization deduction provided by section 169 (a) with respect to such facility and who, prior to the acquisition by such person, had not discontinued the amortization deduction pursuant to section 169 (c), is entitled at his election to a deduction with respect to the amortization of the adjusted basis (determined under section 169 (e) (2)) of such facility based on the period, if any, remaining at the time of his acquisition in the 60-month period elected by the original owner of such facility. For the determination of the adjusted basis of a grain-storage facility in the hands of a subsequent owner for the purpose of the amortization deduction, see § 1.169–6.

(c) *Amount of deduction.* (1) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. If a grain-storage facility is held successively by two or more persons during a single month, the amortization deduction, if any, allowable to each of such persons in respect of that month shall be only that portion of the amount to which each such person would be entitled for a full month which the number of days in such month during which the facility was held by him bears to the total number of days in such month. The adjusted basis of the grain-storage facility at the end of any month shall be computed without regard to the amortization deduction with respect to such facility for such month. The total amortization deduction with respect to a grain-storage facility for a particular taxable year is the sum of the amortization deductions allowable with respect to such facility for each month of the 60-month period which falls within such taxable year.

(2) The amortization deduction with respect to a grain-storage facility for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 167 with respect to the facility for that month. If the original owner of a grain-storage facility elects to begin the 60-month amortization period with the first month of the taxable year succeeding that in which the facility was completed, the deduction for depreciation provided in section 167 is allowable with respect to the facility for the period intervening between the completion of the facility and the beginning of the 60-month period. However, if the original owner elects to begin the 60-month amortization period with the month following that in which the facility was completed, no deduction under section 167 is allowable in respect of the month in which the facility was completed. For depreciation allowable with respect to any amount not subject to amortization, see § 1.169–7.

(d) *Examples.* This section may be illustrated by the following examples:

Example (1). On July 1, 1954, A, who makes his income tax return on a calendar year basis, begins the construction of a grain-storage facility which is completed on September 30, 1954, at a cost of $24,000, not including the cost of the land on which the facility is erected. A elects to take the amortization deduction with respect to the facility and to begin the 60-month amortization period with October 1954, the month following its completion. The adjusted basis of the facility at the end of October is $24,000. The allowable amortization deduction with respect to such facility for the taxable year 1954 is $1,200, computed as follows:

Monthly Amortization Deductions:	
October: $24,000 divided by 60	$400
November: $23,600 ($24,000 minus $400) divided by 59	400
December: $23,200 ($23,600 minus $400) divided by 58	400
Total Amortization Deduction for 1954	1,200

Example (2). The X Corporation, which makes its income tax return on the calendar year basis, begins the construction of a grain-storage facility on June 15, 1954. The facility is completed on August 2, 1954. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with September 1954, the month following its completion. At the end of the first month of the amortization period the adjusted basis of the facility is $30,000. In October 1954, the facility is damaged by fire, as the result of which the adjusted basis is properly reduced by $2,537. The allowable amortization deduction with respect to the facility for the calendar year 1954 is $1,871, computed as follows:

Monthly Amortization Deductions:	
September: $30,000 divided by 60	$500
October: $26,963 ($30,000 minus $500 and $2,537) divided by 59	457
November: $26,506 ($26,963 minus $457) divided by 58	457
December: $26,049 ($26,506 minus $457) divided by 57	457
Total amortization deduction for 1954	1,871

For illustration in the case of a subsequent owner of a grain-storage facility, see example (2) in § 1.169–6 (f).

§ 1.169–4 Election of amortization.

(a) *General rule*—(1) *Original owner.* The election by a taxpayer who constructs, reconstructs, or erects a grain-storage facility to take amortization deductions with respect to the facility and to begin the 60-month amortization period, either with the month following the month in which the facility was completed or with the first month of the taxable year succeeding the taxable year in which such facility was completed, shall be made by a statement to that effect in the taxpayer's return for the taxable year in which falls the first month of the 60-month amortization period so elected. Such statement shall include the following information:

(i) A description clearly identifying each grain-storage facility for which an amortization deduction is claimed.

(ii) The date on which the construction, reconstruction, or erection of each such facility was completed.

(iii) The total costs and expenditures paid or incurred in the construction, reconstruction, or erection of any such facility, excluding the cost of any land.

(iv) If the construction, reconstruction, or erection of any such facility was begun before January 1, 1953, the amount of the costs and expenditures properly attributable to such construction, reconstruction, or erection after December 31, 1952.

(v) In the case of a private grain-storage facility described in paragraph (b) of § 1.169–2, a statement that the taxpayer intends to use the facility for the storage of grain produced or to be produced by him or, in case the election is being made by a partnership, that the structure is intended to be used for the storage of grain produced by one or more members of the partnership.

(2) *Subsequent owner.* The election by a subsequent owner (that is, a person who acquires a grain-storage facility from a taxpayer who elected to take the amortization deduction with respect to the facility and who, prior to the acquisition by the subsequent owner, had not discontinued the amortization deduction under section 169 (c)) to take amortization deductions with respect to the facility shall be made by a statement to that effect in the taxpayer's return for the taxable year in which falls the month in which the facility was acquired. Such statement shall include the following information:

(i) The name and address of the preceding owner.

(ii) The date and the manner of the acquisition of the grain-storage facility from such preceding owner.

(iii) A statement of the basis (unadjusted) of the facility in the hands of the preceding owner for amortization purposes, adjusted to the date of acquisition by the taxpayer.

(iv) A statement of the adjusted basis of the facility in the hands of the taxpayer for amortization purposes, computed as of the date of acquisition by the taxpayer.

(v) In the case of a private grain-storage facility described in paragraph (b) of § 1.169–2, a statement that the taxpayer intends to use the facility for the storage of grain produced or to be produced by him or, in case the election is being made by a partnership, that the structure is intended to be used for the storage of grain produced by one or more members of the partnership.

(b) *Special rules for making election prior to filing of return.* If, prior to the time prescribed in paragraph (a) of this section for making the election to take amortization deductions with respect to a grain-storage facility, such facility is acquired by a subsequent owner, the preceding owner of the facility may make such election within 60 days after the date of acquisition of such facility by the subsequent owner. In the event that the preceding owner dies or ceases to exist prior to making an election, the election may be made within such time by the duly authorized representatives of the preceding owner. Unless the election to take amortization deductions with respect to the facility is made by the preceding owner or on his behalf, the subsequent owner of the facility shall not be entitled to take the amortization deductions allowable under section 169 (a) with respect to such facility. A statement of election under this paragraph shall be filed with the district director for the district in which the return of the taxpayer is required to be filed, and shall contain the same information required with respect to a statement of election under paragraph (a) of this section. However, in the case of a private grain-storage facility described in paragraph (b) of § 1.169–2, in lieu of the statement regarding the intended use of the facility at the time of the election, the statement of election under this paragraph shall include a statement that the preceding owner, at the time of the construction, reconstruction, erection, or acquisition of the facility by him, intended to use the facility for the storage of grain produced or to be produced by him. If the preceding owner of the facility was the original owner, the statement of election must specify the beginning of the 60-month amortization period. Unless the grain-storage facility is acquired from the original owner after the beginning of his taxable year succeeding the taxable year in which such facility was completed, an election made under this paragraph must begin the 60-month amortization period with the month following the month in which the facility was completed.

(c) *Election not made at the time or in the manner prescribed by this section.* (1) The district director has no authority to extend the time prescribed in section 169 (b) and paragraph (a) of this section for making an election to take amortization deductions allowable under section 169 (a). However, the district director in his discretion may, for good cause shown, grant a reasonable extension of time for the making of an election under paragraph (b) of this section.

(2) Except as provided in subparagraph (1) of this paragraph, if a statement of election under paragraph (a) or (b) of this section does not comply with the requirements prescribed therein, it may, in the discretion of the district director and for good cause shown, be made in such manner and form as may be approved by him.

(3) No method of making the election to take the amortization deductions with respect to a grain-storage facility other than those prescribed in this section shall be permitted. A taxpayer who fails to elect to take amortization deductions with respect to such a facility shall not be entitled to amortization deductions with respect to such facility.

(d) *Alteration or remodeling of existing grain-storage facility.* If an existing grain-storage facility, as defined in section 169 (d), is altered or remodeled and such alteration or remodeling is treated under section 169 (d) as the construction of a grain-storage facility (see paragraph (d) of § 1.169–2 and paragraph (e) of § 1.169–6, the part of the facility altered or remodeled is treated as a new and separate grain-storage facility. In such case, unless the taxpayer who completes such alteration or remodeling makes a separate election, in the manner and within the time provided in this section, to take amortization deductions and to begin a new 60-month period with respect to such alteration or remodeling, he shall not be entitled to amortization deductions with respect to such alteration or remodeling. Such alteration or remodeling is also treated as a separate grain-storage facility in the hands of a subsequent owner.

§ 1.169–5 Termination of amortization deduction.

(a) If a taxpayer has elected to take amortization deductions with respect to a grain-storage facility he may, prior to the expiration of the 60-month amortization period and prior to the acquisition of such facility by another person, discontinue the amortization deductions with respect to such facility for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by notice in writing filed with the district director for the district in which the return of the taxpayer is required to be filed, specifying the month as of the beginning of which the taxpayer elects to discontinue such deductions. Such notice shall be filed before the beginning of the month specified therein, and shall contain a description clearly identifying the grain-storage facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer elects in the manner provided herein to discontinue the amortization deductions with respect to a grain-storage facility, he shall not be entitled to any further amortization deductions with respect to such facility.

(b) A taxpayer who elects to discontinue amortization deductions with respect to a grain-storage facility is entitled to a deduction for depreciation under section 167 with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder).

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(c) This section may be illustrated by the following example:

Example. On February 1, 1954, the Y Corporation, which makes its income tax returns on the calendar year basis, begins the construction of a grain-storage facility. The facility is completed on June 30, 1954, at a cost of $306,000, of which $60,000 is allocable to the land and $246,000 to the facility. The corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with July 1954, the month following its completion. On March 25, 1955, the corporation files notice with the district director of its election to discontinue the amortization deductions beginning with the month of April 1955. The adjusted basis of the facility on July 31, 1954, is $246,000. The amortization deductions for the taxable year 1954 and the months of January, February, and March 1955, amount to $36,900, or $4,100 per month for nine months. Accordingly, the adjusted basis of the facility as of April 1, 1955, is $209,100. Beginning as of that date, the deduction for depreciation under section 167 is allowable with respect to the property. Such deduction shall be computed on the adjusted basis ($209,100) of the property as of April 1, 1955.

§ 1.169–6 Adjusted basis of grain-storage facility.

(a) *General.* Section 169(e) provides rules which apply in the determination of the adjusted basis of a grain-storage facility for the purpose of computing the amortization deductions allowable under section 169(a). Section 169(e) does not purport to provide an all-inclusive formula for the computation of adjusted basis for amortization purposes, but only prescribes certain modifications in the amount which would otherwise constitute the adjusted basis of the facility. As a result of these modifications, the adjusted basis for the purpose of computing the amortization deductions allowable with respect to the facility will differ in some cases from the adjusted basis of the facility determined under section 1011 without regard to section 169 (e). The adjusted basis for amortization purposes may also differ from the adjusted basis of the facility for other purposes in that it shall be the adjusted basis for determining gain (see part II (section 1011 and following), subchapter 0, chapter 1 of the Code). The adjusted basis for amortization purposes is derived from the unadjusted basis of the grain-storage facility determined in accordance with the provisions of section 1012. The special rules provided in section 169 (e) are applicable in translating the unadjusted basis determined in accordance with the provisions of section 1012 into the unadjusted basis for amortization purposes under section 169. The unadjusted basis for amortization purposes, less the adjustments properly allocable thereto, becomes the adjusted basis for amortization purposes. These adjustments are those specified in sections 1016 and 1017. However, adjustments which increase the adjusted basis under section 1011 are not to be taken into account in determining the adjusted basis for amortization purposes (see paragraph (d) of this section).

(b) *Original owners.* Section 169 (e) (1) provides rules which apply in the determination of the adjusted basis for amortization purposes of a grain-storage facility in the hands of an original owner (see paragraph (a) of § 1.169–3). As the result of the application of the rules stated in subparagraphs (1) and (2) of this paragraph, the adjusted basis of the facility for amortization purposes will be smaller than the amount which would otherwise constitute the adjusted basis of the facility. The rules are the following:

(1) If the construction, reconstruction, or erection of the facility was begun before January 1, 1953, there is to be included only so much of the entire unadjusted basis of the facility as is properly attributable to construction, reconstruction, or erection after December 31, 1952.

(2) If a structure which is not an existing grain-storage facility as defined in section 169 (d) is altered or remodeled and such alteration or remodeling is treated under section 169 (d) as the construction of a grain-storage facility (see paragraph (d) of § 1.169–2), there is to be included only so much of the entire unadjusted basis of such structure as is properly attributable to such alteration or remodeling as was completed after December 31, 1952, and on or before December 31, 1956. In the case of alteration or remodeling of an existing grain-storage facility, see paragraph (e) of this section.

(c) *Subsequent owners.* A special rule is provided in section 169 (e) (2) for the determination of the adjusted basis for amortization purposes of a grain-storage facility in the hands of a subsequent owner (see paragraph (b) of § 1.169–3). Such adjusted basis is the smaller of the following amounts:

(1) The adjusted basis determined by including an amount in respect of unadjusted basis equal to the adjusted basis of the facility for amortization purposes in the hands of the preceding owner, determined as of the date of acquisition of the facility by the taxpayer. For the purpose of this paragraph, in determining the adjusted basis of the facility for amortization purposes in the hands of the preceding owner the adjustments required under section 1016 shall include an adjustment in respect of the amount of the amortization deduction allowable to the preceding owner for the month in which the facility was acquired by the taxpayer. See paragraph (c) of § 1.169–3. For the rule excluding capital additions from the adjusted basis of a grain-storage facility for amortization purposes, see paragraph (d) of this section.

(2) The adjusted basis (computed under section 1011 for determining gain) of the facility in the hands of the taxpayer. If the construction, reconstruction, or erection of the facility was begun before January 1, 1953, in determining such adjusted basis there is to be included only so much of the entire unadjusted basis of the facility (in the hands of the taxpayer) as is properly attributable to construction, reconstruction, or erection after December 31, 1952.

(d) *Capital additions.* If after the completion or acquisition of a grain-storage facility further expenditures are made for construction, reconstruction, or erection, such expenditures shall not be added to the adjusted basis of the facility for amortization purposes. If such expenditures result in alteration or remodeling which under section 169 (d) is treated as the construction of a grain-storage facility, see paragraph (e) of this section.

(e) *Alteration or remodeling of existing grain-storage facility.* If an existing grain-storage facility as defined in section 169 (d) is altered or remodeled and such alteration or remodeling is treated under section 169 (d) as the construction of a grain-storage facility (see paragraph (d) of § 1.169–2), the expenditures for such alteration or remodeling shall not be applied in adjustment of the basis of the existing facility, but a separate basis shall be computed by reference to such expenditures as if such alteration or remodeling represented a new and separate grain-storage facility. A structure which was not an existing grain-storage facility prior to alteration or remodeling which is treated under section 169 (d) as the construction of a grain-storage facility becomes an existing grain-storage facility for the purposes of this paragraph. Thus, if a structure which is an existing grain-storage facility by reason of such alteration or remodeling is again altered or remodeled and such alteration or remodeling is treated under section 169 (d) as the construction of a grain-storage facility, the provisions of this subparagraph are also applicable to such later alteration or remodeling.

(f) *Examples.* The computation of the adjusted basis of a grain-storage facility for amortization purposes may be illustrated in the following examples:

Example (1). On February 28, 1953, A completes the construction of a grain-storage facility as defined in section 169 (d) at a cost $2,000 for the land and $6,000 for the construction. Only $3,000 of the total cost of the facility is properly attributable to construction after December 31, 1952. A elects to claim the amortization deduction and to begin the 60-month period on March 1, 1953. Under section 169 (e), the adjusted basis of the facility for the purpose of section 169 (a) as of that date is only $3,000, the amount attributable to construction after December 31, 1952. In determining the adjusted basis of the facility as of any subsequent date for the purpose of computing the amortization deduction, the amortization deductions allowable in respect of the period prior to such date must be taken into account. See section 1016. Thus, the adjusted basis of the facility for the purpose of computing the amount of the amortization deduction allowable for the month of January 1954, is $2,500 ($3,000 minus $500, the amortization deductions allowable prior to January 1, 1954).

Example (2). A began on January 1, 1954, and completed on June 30, 1954, the construction of a grain-storage facility as defined in section 169 (d) at a cost of $5,000 for the land and $30,000 for the construction. A elects to claim the amortization deduction and to begin the 60-month period on July 1, 1954. On May 1, 1955, A sells the grain-storage facility to B for a price of $34,000, of which $6,000 is allocable to the land. B elects to claim the amortization deduction on the basis of the 50 months remaining in the amortization period. B, in determining the adjusted basis of the facility in his hands, must start with the unadjusted basis of the facility in the hands of A ($30,000) and adjust such basis under section 1016 in respect of amortization claimed by A during his

ownership of the facility ($5,000). Since this amount ($25,000) is smaller than the

facility computed under section 169 (e)

(B) *General limitation.* The total deductions under subsection (a) for any taxable

year under the foregoing limitation shall be deductible in each of the two succeeding

ownership of the facility ($5,000). Since this amount ($25,000) is smaller than the adjusted basis (for determining gain) of the facility in B's hands as of May 1, 1955 ($28,000, that is $34,000 less $6,000 allocable to land), the adjusted basis of the facility for the purpose of section 169 (a) in B's hands as of May 1, 1955, is $25,000. B, therefore, may include only $25,000 in determining the adjusted basis of the facility in his hands as of May 1, 1955, the date of the purchase. The amortization deductions claimed by B must, of course, be applied in reduction of such adjusted basis in determining the adjusted basis of the facility as of any subsequent date for the purpose of his amortization deduction under section 169 (a). The amount by which the purchase price paid by B and allocable to depreciable property ($28,000) exceeds the adjusted basis determined under section 169 (e) for such property ($25,000)—or $3,000—is treated as the adjusted basis (as of May 1, 1955) for the purpose of the depreciation deduction allowable under section 167. See § 1.169–7.

§ 1.169–7 Depreciation of portion of grain-storage facility not subject to amortization.

The rule set forth in section 169(a) (see § 1.169–3), that the amortization deduction with respect to a grain-storage facility is in lieu of any deduction for depreciation which would otherwise be allowable under section 167 with respect to the facility, is subject to an exception provided in section 169(f). Under this exception, if the adjusted basis of the facility as computed under section 1011 for purposes other than the amortization deductions (see § 1.1011–1) is in excess of the adjusted basis computed under section 169 (e) for the purpose of the amortization deductions (see § 1.169–6), any excess shall be charged off over the useful life of the facility and recovered through depreciation deductions allowable under section 167. Thus, if the construction of a grain-storage facility was begun before January 1, 1953, no amortization deductions are allowable with respect to the amount attributable to such construction before such date (see § 1.169–6). However, the depreciation deduction provided by section 167 and the regulations thereunder is allowable with respect to the amount attributable to construction before January 1, 1953. Similarly, in the case of a subsequent owner the adjusted basis of a grain-storage facility computed under section 1011 for purposes other than the amortization deductions (see § 1.1011–1) may exceed the adjusted basis of the facility computed under section 169 (e) for amortization purposes. In such case the excess will be subject to the allowance for depreciation provided by section 167. For illustration of the treatment of the portion of a grain-storage facility which is subject to the allowance for depreciation, see example (2) in paragraph (f) of § 1.169–6.

§ 1.169–8 Life tenant and remainderman.

In the case of a grain-storage facility held by one person for life with the remainder to another person, the amortization deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant during his life.

§ 1.170 Statutory provisions; charitable, etc., contributions and gifts.

SEC. 170. *Charitable, etc., contributions and gifts*—(a) *Allowance of deduction*—(1) *General rule.* There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

(2) *Corporations on accrual basis.* In the case of a corporation reporting its taxable income on the accrual basis, if—

(A) The board of directors authorizes a charitable contribution during any taxable year, and

(B) Payment of such contribution is made after the close of such taxable year and on or before the 15th day of the third month following the close of such taxable year,

then the taxpayer may elect to treat such contribution as paid during such taxable year. The election may be made only at the time of the filing of the return for such taxable year, and shall be signified in such manner as the Secretary or his delegate shall by regulations prescribe.

(b) *Limitations*—(1) *Individuals.* In the case of an individual the deduction provided in subsection (a) shall be limited as provided in subparagraphs (A), (B), (C), and (D)

(A) *Special rule.* Any charitable contribution to—

(i) A church or a convention or association of churches,

(ii) An educational organization referred to in section 503 (b) (2), or

(iii) A hospital referred to in section 503 (b) (5),

shall be allowed to the extent that the aggregate of such contributions does not exceed 10 percent of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172.

(B) *General limitation.* The total deductions under subsection (a) for any taxable year shall not exceed 20 percent of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172. For purposes of this subparagraph, the deduction under subsection (a) shall be computed without regard to any deduction allowed under subparagraph (A) but shall take into account any charitable contributions to the organizations described in clauses (i), (ii), and (iii) which are in excess of the amount allowable as a deduction under subparagraph (A).

(C) *Unlimited deduction for certain individuals.* The limitation in subparagraph (B) shall not apply in the case of an individual if, in the taxable year and in 8 of the 10 preceding taxable years, the amount of the charitable contributions, plus the amount of income tax (determined without regard to chapter 2, relating to tax on self-employment income) paid during such year in respect of such year or preceding taxable years, exceeds 90 percent of the taxpayer's taxable income for such year, computed without regard to—

(i) This section,

(ii) Section 151 (allowance of deductions for personal exemptions), and

(iii) Any net operating loss carryback to the taxable year under section 172.

(D) *Denial of deduction in case of certain transfers in trust.* No deduction shall be allowed under this section for the value of any interest in property transferred after March 9, 1954, to a trust if—

(i) The grantor has a reversionary interest in the corpus or income of that portion of the trust with respect to which a deduction would (but for this subparagraph) be allowable under this section; and

(ii) At the time of the transfer the value of such reversionary interest exceeds 5 percent of the value of the property constituting such portion of the trust.

For purposes of this subparagraph, a power exercisable by the grantor or a nonadverse party (within the meaning of section 672 (b)), or both, to revest in the grantor property or income therefrom shall be treated as a reversionary interest.

(2) *Corporations.* In the case of a corporation, the total deductions under subsection (a) for any taxable year shall not exceed 5 percent of the taxpayer's taxable income computed without regard to—

(A) This section,

(B) Part VIII (except section 248),

(C) Any net operating loss carryback to the taxable year under section 172, and

(D) Section 922 (special deduction for Western Hemisphere trade corporations).

Any contribution made by a corporation in a taxable year to which this section applies in excess of the amount deductible in such year under the foregoing limitation shall be deductible in each of the two succeeding taxable years in order of time, but only to the extent of the lesser of the two following amounts: (i) the excess of the maximum amount deductible for such succeeding taxable year under the foregoing limitation over the contributions made in such year; and (ii) in the case of the first succeeding taxable year the amount of such excess contribution, and in the case of the second succeeding taxable year the portion of such excess contribution not deductible in the first succeeding taxable year.

(c) *Charitable contribution defined.* For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

(1) A State, a Territory, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

(2) A corporation, trust, or community chest, fund, or foundation—

(A) Created or organized in the United States or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States;

(B) Organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

(C) No part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) No substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization—

(A) Organized in the United States or any of its possessions, and

(B) No part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation

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and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.

(d) *Disallowance of deductions in certain cases.* (1) For disallowance of deductions in case of contributions or gifts to charitable organizations engaging in prohibited transactions, see section 503 (e).

(2) For disallowance of deductions for contributions to or for the use of communist controlled organizations, see section 11 (a) of the Internal Security Act of 1950 (64 Stat. 996; 50 U. S. C. 790).

(e) *Other cross references.* (1) For charitable contributions of estates and trusts, see section 642 (c).

(2) For nondeductibility of contributions by common trust funds, see section 584.

(3) For charitable contributions of partners, see section 702.

(4) For charitable contributions of nonresident aliens, see section 873.

(5) For treatment of gifts for benefit of or use in connection with the Naval Academy as gifts to or for the use of the United States, see section 3 of the Act of March 31, 1944 (58 Stat. 135; 34 U. S. C. 1115b).

(6) For treatment of gifts for benefit of the library of the Post Office Department as gifts to or for the use of the United States, see section 2 of the Act of August 8, 1946 (60 Stat. 924; 5 U. S. C. 393).

(7) For treatment of gifts accepted by the Secretary of State under the Foreign Service Act of 1946 as gifts to or for the use of the United States, see section 1021 (e) of that Act (60 Stat. 1032; 22 U.S.C. 809(e)).

(8) For treatment of gifts of money accepted by the Attorney General for credit to the "Commissary Funds Federal Prisons" as gifts to or for the use of the United States, see section 2 of the Act of May 15, 1952 (66 Stat. 73, as amended by the Act of July 9, 1952, 66 Stat. 479, 31 U. S. C. 725s–4).

§ 1.170–1 Charitable, etc., contributions and gifts; allowance of deduction.

(a) *General rule.* Any charitable contribution (as defined in section 170 (c)) actually paid during the taxable year is allowable as a deduction in computing taxable income, regardless of the method of accounting employed or when pledged. In addition, contributions by corporations may under certain circumstances be deductible even though not paid during the taxable year (see § 1.170–3). The deduction is subject to the limitations of section 170 (b) (see §§ 1.170–2 and 1.170–3) and is subject to verification by the district director. In connection with claims for deductions for charitable contributions, taxpayers shall state in their income tax returns the name and address of each organization to which a contribution was made and the amount and approximate date of the actual payment of each contribution. Any deduction for a charitable contribution must be substantiated, when required by the district director, by a statement from the organization to which the contribution was made indicating whether the organization is a domestic organization, the name and address of the contributor, the amount of the contribution, and the date of its actual payment, and by such other information as the district director may deem necessary.

(b) *Time of making contribution.* Ordinarily a contribution is made at the time delivery is effected. In the case of a check, the unconditional delivery (or mailing) of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery (or mailing). If a taxpayer unconditionally delivers a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery. If the donor delivers the certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.

(c) *Contribution in property.* If a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the lowest usual market in which he customarily sells, at the time and place of the contribution (and in the case of a contribution of goods in quantity, in the quantity contributed). The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, unless he sells only at retail in which event it is his retail customers. If a donor makes a charitable contribution of, for example, stock in trade at a time when he could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is the amount for which the quantity of merchandise contributed would have been sold by the donor at the time of the contribution. Costs and expenses incurred in the year of contribution in producing or acquiring the contributed property are not deductible and are not a part of the cost of goods sold. Similarly, to the extent that costs and expenses incurred in a prior taxable year in producing or acquiring the contributed property are reflected in the cost of goods sold in the year of contribution, cost of goods sold must be reduced by such costs and expenses. Transfers of property to an organization described in section 170 (c) which bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See sections 162 and the regulations thereunder.

(d) *Transfers of income and remainder interests.* A deduction may be allowed for a contribution of an interest in the income from property or an interest in the remainder. The income or remainder interest shall be valued according to the tables referred to in paragraph (d) of § 1.170–2. For rules with respect to certain transfers to a trust, see paragraph (d) of § 1.170–2.

(e) *Transfers subject to a condition or a power.* If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest passes to or is vested in charity on the date of the gift and the interest would be defeated by the performance of some act or the happening of some event, the occurrence of which appeared to have been highly improbable on the date of the gift, the deduction is allowable. The deduction is not allowed in the case of a transfer in trust conveying a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest. For example, assume that assets placed in trust consist of stock in a corporation the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees were not members of the donor's family but had no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction would be allowed.

(f) *Exceptions.* (1) This section does not apply to contributions by estates and trusts (see section 642 (c)). For disallowance of certain charitable deductions otherwise allowable under section 170, see sections 503 (e) and 681 (b) (5) (relating to organizations engaged in prohibited transactions). For disallowance of deductions for contributions to or for the use of communist controlled organizations, see section 11 (a) of the Internal Security Act of 1950, as amended (50 U.S.C. 790). For denial of deduction for charitable contributions as trade or business expenses and rules with respect to treatment of payments to organizations other than those described in section 170(c), see section 162 and the regulations thereunder.

(2) No deduction shall be allowed under section 170 for amounts paid to an organization—

(i) A substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, or

(ii) Which participates in or intervenes in any political campaign on behalf of any candidate for public office.

For purposes of determining whether an organization is attempting to influence legislation or is engaging in political activities, see section 501 (c) (3) and the regulations thereunder. Moreover, no deduction shall be allowed under section

170 for expenditures for lobbying purposes, promotion or defeat of legislation,

tional 10-percent deduction. For exam-

available to a church, school, or hospital

170 for expenditures for lobbying purposes, promotion or defeat of legislation, etc. See also the regulations under section 162.

(3) No deduction for charitable contributions is allowed in computing the taxable income of a common trust fund or of a partnership. See sections 584 (d) and 703 (a) (2) (D). However, a partner's distributive share of charitable contributions actually paid by a partnership during its taxable year may be allowed as a deduction in the partner's separate return for his taxable year with or within which the taxable year of the partnership ends, to the extent that the aggregate of his share of the partnership contributions and his own contributions does not exceed the limitations in section 170 (b). In the case of a nonresident alien individual, or a citizen of the United States entitled to the benefits of section 931, see sections 873 (c), 876, and 931.

§ 1.170–2 Charitable deductions by individuals; limitations.

(a) *In general.* (1) A deduction is allowable to an individual under section 170 only for charitable contributions actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A contribution to an organization described in section 170(c) is deductible even though some portion of the funds of the organization may be used in foreign countries for charitable or educational purposes. The deduction by an individual for charitable contributions under section 170 is limited generally to 20 percent of the taxpayer's adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172). If a husband and wife make a joint return, the deduction for contributions is the aggregate of the contributions made by the spouses, and the limitation in section 170 (b) is based on the aggregate adjusted gross income of the spouses. The 20-percent limitation applies to amounts contributed during the taxable year "to or for the use of" those recipients described in section 170 (c). The limitation is computed without regard to contributions qualifying for the additional 10-percent deduction. For examples of the application of the 10 and 20-percent limitation, see paragraph (b) (5) of this section.

(2) No deduction is allowable for contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in rendering donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of rendering donated services also are deductible. For the purposes of this section, the phrase "while away from home" has the same meaning as that phrase is used for purposes of section 162.

(3) (i) In the case of an annuity or portion thereof purchased from an organization described in section 170 (c), there shall be allowed as a deduction the excess of the amount paid over the value at the time of purchase of the annuity or portion purchased.

(ii) The value of the annuity or portion is the value of the annuity determined in accordance with section 101 (b) and the regulations thereunder.

(b) *Additional 10-percent deduction—* (1) *In general.* In addition to the deduction which may be allowed for contributions subject to the general 20-percent limitation, an individual may deduct contributions made during the taxable year "to", but not merely "for the use of", a church or a convention or association of churches, an educational organization referred to in section 503 (b) (2) and defined in subparagraph (3) of this paragraph, or a hospital defined in subparagraph (4) of this paragraph, to the extent that such contributions in the aggregate do not exceed 10 percent of his adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172). A contribution made to a trust, community chest, or other organization referred to in section 170 (c), which in turn makes the contribution available to a church, school, or hospital, will not qualify under the 10-percent limitation, unless such trust, community chest, or other organization acts merely as an agent of the taxpayer in delivering the contribution. The computation of this additional deduction is not necessary unless the total contributions paid during the taxable year are in excess of the general 20-percent limitation. Where the total contributions exceed the 20-percent limitation, the taxpayer should first ascertain the amount of charitable contributions subject to the 10-percent limitation, and any excess over the 10-percent limitation should then be added to all other contributions and limited by the 20-percent limitation.

(2) *Church.* For definition of "church", see the regulations under section 511.

(3) *Educational organization.* An "educational organization" within the meaning of section 170 (b) (1) (A) is one whose primary function is the presentation of formal instruction and which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term, therefore, includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to and growing out of the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization. However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization. A gift to an educational institution through an alumni association or a class organization, which acts simply as a fund-raising or collection agency through which gifts may be made currently to the institution, is a gift to the educational organization if the entire gift inures to its benefit, but not if any part of it inures to the general or operating fund of the agency. Similarly, a gift to one or more educational institutions through an association of educational institutions will be considered a gift to the institutions if it inures entirely to their benefit.

(4) *Hospital.* The term "hospital", as used in section 170 (b) (1) (A), means an organization the principal purposes or functions of which are providing hospital or medical care. The term includes Federal and State hospitals otherwise coming within the definition but does not include medical education or research organizations. (See, however, the Act of August 7, 1956 (Public Law 1022, 84th Cong., 70 Stat. 1117), relating to contributions to certain medical research organizations.) A rehabilitation institution or an out-patient clinic may qualify as a hospital if its principal purposes or functions are the providing of hospital or medical care. The term "hospital" does not include convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purposes or functions are to train handicapped individuals to pursue some vocation.

(5) *Examples.* The application of the special 10-percent limitation and the general 20-percent limitation on contributions by individuals may be illustrated by the following examples:

Example (1). A, an individual, reports his income on the calendar year basis and for the year 1957 has an adjusted gross income of $10,000. During 1957 he made the following charitable contributions:

1. Contributions qualifying for the additional 10-percent deduction under section 170 (b) (1) (A)	$2,400
2. Other charitable contributions	700
3. Total contributions paid	3,100

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		Deductible contributions
4. Contributions qualifying for the additional 10-percent deduction under section 170 (b) (1) (A)	$2,400	
5. Special limitation under section 170 (b) (1) (A): 10 percent of adjusted gross income	1,000	
6. Deductible amount: line 4 or line 5, whichever is the lesser		$1,000
7. Excess of line 4 over line 5	1,400	
8. Add: Other charitable contributions	700	
9. Contributions subject to the general 20-percent limitation under section 170 (b) (1) (B)	2,100	
10. Limitation under section 170(b)(1)(B): 20-percent of the adjusted gross income	2,000	
11. Deductible amount: line 9 or line 10, whichever is the lesser		2,000
12. Contributions not deductible	100	
13. Total deduction for contributions		3,000

Example (2). B, an individual, reports his income on the calendar year basis and for the year 1957 has an adjusted gross income of $10,000. During 1957 he made the following charitable contributions:

1. Contributions qualifying for the additional 10-percent deduction under section 170 (b) (1) (A)	$700	
2. Other charitable contributions	2,400	
3. Total contributions paid	3,100	
4. Contributions qualifying for the additional 10-percent deduction under section 170 (b) (1) (A)	$700	
5. Limitation described in section 170 (b) (1) (A): 10 percent of the adjusted gross income	1,000	
6. Deductible amount: line 4 or line 5, whichever is the lesser		$700
7. Excess of line 4 over line 5	0	
8. Add: Other charitable contributions	2,400	
9. Contributions subject to the general 20-percent limitation under section 170 (b) (1) (B)	$2,400	
10. Limitation under section 170 (b) (1) (B): 20 percent of the adjusted gross income	2,000	
11. Deductible amount: line 9 or line 10, whichever is the lesser		2,000
12. Contributions not deductible	400	
13. Total deduction for contributions		2,700

(c) *Unlimited deduction for individuals*—(1) *In general.* The deduction for charitable contributions made by an individual is not subject to the 10 and 20-percent limitations of section 170(b) if in the taxable year and each of 8 of the 10 preceding taxable years the sum of his charitable contributions paid during the year, plus his payments during the year on account of Federal income taxes, is more than 90 percent of his taxable income for the year (or net income, in years governed by the Internal Revenue Code of 1939). For the purpose of the preceding sentence, taxable income under the Internal Revenue Code of 1954 is determined without regard to the deductions for charitable contributions under section 170, for personal exemptions under section 151, or for a net operating loss carryback under section 172. On the other hand, for this purpose net income under the Internal Revenue Code of 1939 is computed without the benefit only of the deduction for charitable contributions. See section 120 of the Internal Revenue Code of 1939. The term "income tax" as used in section 170 (b) (1) (C) means only Federal income taxes, and does not include the taxes imposed on self-employment income, on employees under the Federal Insurance Contributions Act (chapter 21 of the Code) or on railroad employees and their representatives under the Railroad Retirement Tax Act (chapter 22 of the Code) by chapters 2, 21, and 22, respectively, or corresponding provisions of the Internal Revenue Code of 1939. For purposes of section 170(b)(1)(C) and this paragraph, the amount of income tax paid during a taxable year shall be determined by including all payments made by the taxpayer during such taxable year on account of his Federal income taxes (whether for the taxable year or for preceding taxable years). Such payments would include any amount paid during the taxable year as estimated tax for that year, payment of the final installment of estimated tax for the preceding taxable year, final payment for the preceding taxable year, and any payment of a deficiency for an earlier taxable year, to the extent that such payments do not exceed the tax for the taxable year for which payment is made. However, any payment of income tax with respect to which the taxpayer receives a refund or credit shall be reduced by the amount of such refund or credit. Any such refund or credit shall be applied against the most recent payments for the taxable year in respect of which the refund or credit arose.

(2) *Joint Returns*—(i) *Joint return for current taxable year.* If a husband and wife make a joint return for any taxable year, their deduction for charitable contributions is not subject to the 10 and 20-percent limitations of section 170 (b), if, under the rules of subparagraph (1) of this paragraph, in the taxable year and in each of 8 of the 10 preceding taxable years (regardless of whether separate or joint returns were filed) the aggregate charitable contributions of both spouses paid during the year, plus their aggregate payments during the year on account of Federal income taxes, exceed 90 percent of their aggregate taxable incomes for the year.

(ii) *Separate return by spouse or by unremarried widow or widower.* If a spouse, or the unremarried widow or widower of a deceased spouse, makes a separate return for any taxable year, his deduction for charitable contributions is not subject to the 10- and 20-percent limitations of section 170(b), if, under the rules of subparagraph (1) of this paragraph, in the taxable year and each of 8 of the 10 preceding taxable years—

(*a*) For which the taxpayer filed a joint return with his spouse, either their aggregate charitable contributions and payments of Federal income taxes made during the year exceed 90 percent of their aggregate taxable income for the year, or the taxpayer's separate charitable contributions and payments of Federal income taxes (allocable to his separate income) made during the year exceed 90 percent of his separate taxable income for the year, and

(*b*) For which the taxpayer did not file a joint return with his spouse, his charitable contributions and payments on account of Federal income taxes made during the year exceed 90 percent of his taxable income for the year.

For the purpose of the preceding sentence, the word "spouse" does not include a spouse from whom the taxpayer has been divorced.

(iii) *Joint return with former spouse for prior taxable year.* A divorced or remarried taxpayer who filed a joint return for a prior taxable year with a former spouse shall, for purposes of applying this paragraph, be treated in the same manner as if he had filed a separate return for such prior taxable year, and as if his Federal income tax liability and taxable income for such prior taxable year were his allocable portions of the joint tax liability and combined taxable income, respectively, for such year.

(iv) *Allocation.* Whenever it is necessary to allocate the joint tax liability or the combined taxable income, or both, for a taxable year for which a joint return was filed, a computation shall be made for the taxpayer and for his spouse or former spouse showing for each of them the Federal income taxes and taxable income which would be determined if separate returns had been filed by them for such taxable year. The joint tax liability and combined taxable income for such taxable year shall then be allocated proportionately to the income taxes and taxable income, respectively, so computed. Whenever it is necessary to determine the separate payments made by a taxpayer in respect of a joint tax liability, the amount paid by him during the taxable year as estimated tax for that

year shall be included to the extent it does not exceed his allocable portion of

grantor after a number of years certain,

(1) The deduction for charitable con-

amount deductible in that year under

year shall be included to the extent it does not exceed his allocable portion of the joint tax for the taxable year, and any amount paid by him for a prior year (whether as the final installment of estimated tax for the preceding taxable year, or a final payment for the preceeding year, or the payment of a deficiency for an earlier year) shall be included to the extent such amount, when added to amounts previously paid by him for such prior year, does not exceed his allocable portion of the joint tax liability for the prior year.

(d) *Denial of deduction in case of certain transfers in trust*—(1) *Reversionary interest in grantor.* No charitable deduction will be allowed for the value of any interest in property transferred to a trust after March 9, 1954, if the grantor at the time of the transfer has a reversionary interest in the corpus or income and the value of such reversionary interest exceeds 5 percent of the total value on which the charitable deduction would, but for section 170 (b) (1) (D), be determined. For purposes of this paragraph, the term "reversionary interest" means a possibility that after the possession or enjoyment of property or its income has been obtained by a charitable donee, the property or its income may revest in the grantor or his estate, or may be subject to a power exercisable by the grantor or a nonadverse party (within the meaning of section 672 (b)), or both, to revest in, or return to or for the benefit of, the grantor or his estate the property or income therefrom. An interest of the grantor which, in any event, will terminate before the ripening of the assured charitable gift for which a deduction is claimed is not considered a reversionary interest for purposes of this section. For example, assume that a taxpayer conveyed property to a trust under the terms of which the income is payable to the taxpayer's wife for her life, and, if she predeceases him, to him for his life, and after the death of both the property is to be transferred to a charitable organization.

(2) *Valuation of interests.* The present value of the remainder interest in the property, taking into account the value of the life estates reserved to the taxpayer and his wife, may be allowed as a charitable deduction. Where the corpus of the trust is to return to the grantor after a number of years certain, the value of the reversionary interest at the time of the transfer may be computed by the use of tables showing the present value at 3½ percent a year, compounded annually, of $1 payable at the end of a number of years certain. See paragraph (f), Table II, of § 20.2031–7 of this chapter (Estate Tax Regulations). Where the value of a reversionary interest is dependent upon the continuation or termination of the life of one or more persons, it must be determined on the basis of Table 38 of United States Life Tables and Actuarial Tables 1939–1941, published by the United States Department of Commerce, Bureau of the Census, and interest at the rate of 3½ percent a year, compounded annually. See paragraph (f), Table I, of § 20.2031–7 of this chapter (Estate Tax Regulations) for valuations based on one life, and "Actuarial Values for Estate and Gift Tax" (Internal Revenue Service Publication No. 11, Rev. 5–59) for values based on more than one life. In an actual case (not merely hypothetical), the grantor or his legal representative may, upon request, obtain the information necessary to determine such a value from the district director with whom the grantor files his return. The request must be accompanied by a statement showing the date of birth of each person the duration of whose life may affect the value of the reversionary interest and by copies of the instruments relevant to the transfer.

(e) *Fiscal years and short taxable years ending after March 9, 1954, subject to the Internal Revenue Code of 1939.* Pursuant to section 7851 (a) (1) (C) of the Internal Revenue Code of 1954, the regulations prescribed in paragraph (d) of this section, to the extent that they relate to transfers in trust occurring after March 9, 1954, shall apply to all taxable years ending after March 9, 1954, even though those years may be subject to the Internal Revenue Code of 1939.

§ 1.170–3 Contributions or gifts by corporations.

(a) *In general.* The deduction by a corporation in any taxable year for charitable contributions, as defined in section 170(c), is limited to 5 percent of its taxable income for the year, computed without regard to:

(1) The deduction for charitable contributions,

(2) The special deductions for corporations allowed under part VIII (except section 248), subchapter B, chapter 1 of the Code.

(3) Any net operating loss carryback to the taxable year under section 172, and

(4) The special deduction for Western Hemisphere trade corporations under section 922.

A contribution by a corporation to a trust, chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals is deductible only if the contribution is to be used in the United States or its possessions for those purposes. See section 170 (c) (2). For the purposes of section 170, amounts excluded from the gross income of a corporation under section 114 (relating to sports programs conducted for the American National Red Cross) are not to be considered contributions or gifts. For disallowance of certain charitable, etc., deductions, see paragraph (f) of § 1.170–1.

(b) *Election by corporations on an accrual method.* A corporation reporting its taxable income on an accrual method may elect to have a charitable contribution (as defined in section 170 (c)) considered as paid during the taxable year, if payment is actually made on or before the fifteenth day of the third month following the close of the year and if, during the year, the board of directors authorized the contribution. The election must be made at the time the return for the taxable year is filed, by reporting the contribution on the return. There shall be attached to the return when filed a written declaration that the resolution authorizing the contribution was adopted by the board of directors during the taxable year, and the declaration shall be verified by a statement signed by an officer authorized to sign the return that it is made under the penalties of perjury. There shall also be attached to the return when filed a copy of the resolution of the board of directors authorizing the contribution.

(c) *Charitable contributions carryover of corporations.* (1) Any contributions made by a corporation in a taxable year subject to the Code in excess of the amount deductible in that year under the 5-percent limitation of section 170 (b) (2) are deductible in each of the two succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for the succeeding year under the 5-percent limitation of section 170 (b) (2) over the contributions made in that year; and

(ii) In the case of the first succeeding taxable year, the amount of the excess contributions; and, in the case of the second succeeding taxable year, the portion of the excess contributions not deductible in the first succeeding taxable year.

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $10,000 in June 1957, anticipating taxable income for 1957 of $200,000. Its actual taxable income (without regard to any deduction for charitable contributions) for 1957 is only $50,000 and the charitable deduction for that year is limited to $2,500 (5 percent of $50,000). The excess charitable contribution not deductible in 1957 ($7,500) represents a carryover potentially available as a deduction in the two succeeding taxable years. The corporation has taxable income (without regard to any deduction for charitable contributions) of $150,000 in 1958 and makes a charitable contribution of $2,500 in that year. For 1958, the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists first of the $2,500 contribution made in 1958, and $5,000 of the $7,500 carried over from 1957. The remaining $2,500 carried over from 1957 and not allowable as a deduction in 1958 because of the 5-percent limitation may be carried over to 1959. The corporation has taxable income (without regard to any deduction for charitable contributions) of $100,000 in 1959 and makes a charitable contribution of $3,000. For 1959, the corporation may deduct under section 170 the amount of $5,000 (5 percent of $100,000). This amount consists first of the $3,000 contributed in 1959, and $2,000 of the $2,500 carried over from 1957 to 1959. The remaining $500 of the carryover from 1957 is not allowable as a deduction in any year because of the 2-year limitation provision of section 170 (b) (2).

§ 1.171 Statutory provisions; amortizable bond premium.

SEC. 171. *Amortizable bond premium*—(a) *General rule.* In the case of any bond, as defined in subsection (d), the following

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rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond:

(1) *Interest wholly or partially taxable.* In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.* In the case of any bond the interest on which is excludable from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit or deduction for interest partially tax-exempt*—(A) *Individuals.* In the case of any bond the interest on which is allowable as a credit under section 35, the amount which would otherwise be taken into account in computing such credit shall be reduced by the amount of the amortizable bond premium for the taxable year.

(B) *Corporations.* In the case of any bond the interest on which is allowable as a deduction under section 242, such deduction shall be reduced by the amount of the amortizable bond premium for the taxable year.

(4) *Cross reference.* For adjustment to basis on account of amortizable bond premium, see section 1016 (a) (5).

(b) *Amortizable bond premium*—(1) *Amount of bond premium.* For purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined—

(A) With reference to the amount payable on maturity or on earlier call date (but in the case of bonds described in subsection (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, only if such earlier call date is a date more than 3 years after the date of such issue), and

(B) With reference to the amount payable on maturity or on an earlier call date (but in the case of bonds described in subsection (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, only if such earlier call date is a date more than 3 years after the date of such issue), and

(C) With adjustments proper to reflect unamortized bond premium, with respect to the bond, for the period before the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.* The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. In the case of a bond described in subsection (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue, the amount of bond premium attributable to the taxable year in which the bond is called shall include an amount equal to the excess of the amount of the adjusted basis (for determining loss on sale or exchange) of such bond as of the beginning of the taxable year over the amount received on redemption of the bond or (if greater) the amount payable on maturity.

(3) *Method of determination.* The determinations required under paragraphs (1) and (2) shall be made—

(A) In accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) In all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium prescribed by the Secretary or his delegate.

(c) *Election as to taxable and partially taxable bonds*—(1) *Eligibility to elect; bonds with respect to which election permitted.* This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply:

(A) *Partially tax-exempt.* In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 35 is allowable; and

(B) *Wholly taxable.* In the case of any taxpayer, bonds the interest on which is not excludable from gross income but with respect to which the credit provided in section 35, or the deduction provided in section 242, is not allowable.

(2) *Manner and effect of election.* The election authorized under this subsection shall be made in accordance with such regulations as the Secretary or his delegate shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to revoke such election. In the case of bonds held by a common trust fund, as defined in section 584 (a), or by a foreign personal holding company, as defined in section 552, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company. In case of bonds held by an estate or trust, the election authorized under this subsection shall be exercisable with respect to such bonds only by the fiduciary.

(d) *Bond defined.* For purposes of this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(e) *Dealers in tax-exempt securities.* For special rules applicable, in the case of dealers in securities, with respect to premium attributable to certain wholly tax-exempt securities, see section 75.

§ 1.171–1 Amortizable bond premium.

(a) *In general.* Under section 171, bond premium is amortizable by the owner of the bond (as defined in § 1.171–4) in accordance with subparagraph (1) or (2) of this paragraph as follows:

(1) Amortization of bond premium is mandatory with respect to—

(i) Fully tax-exempt bonds (the interest on which is excludable from gross income), whether the owner is a corporation, individual, or other taxpayer; and

(ii) Partially tax-exempt bonds owned by a corporation.

(2) Amortization of bond premium is optional, at the election of the taxpayer, with respect to—

(i) Fully taxable bonds, whether the owner is a corporation, individual, or other taxpayer; and

(ii) Partially tax-exempt bonds owned by taxpayers other than corporations.

(b) *Operation.* (1) In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bond. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. See paragraph (b) (2) of § 1.171–2 for treatment of bonds with alternative call dates.

(2) In the case of a fully taxable bond to which section 171 is applicable, the amortizable bond premium is applied both as an adjustment to the basis or adjusted basis of the bond and as a deduction in computing taxable income. For the disallowance of a deduction in certain cases, see paragraph (a) (3) of § 1.171–2.

(3) In the case of a partially tax-exempt bond, the amortizable bond premium for the taxable year is used for the following purposes:

(i) As an adjustment to the basis or adjusted basis of the bond;

(ii) As a deduction in computing taxable income;

(iii) In the case of individuals, estates, or trusts, as a reduction of the amount which would otherwise be taken into account in computing the credit against the tax provided under section 35; or

(iv) In the case of corporations, as a reduction of the amount allowed under section 242 as a deduction in computing taxable income.

(4) The application of the provisions of subparagraph (3) of this paragraph relating to a partially tax-exempt bond may be illustrated by the following example:

Example. In the case of an individual who has elected to amortize the premium on a partially tax-exempt bond, if the interest on such bond with an adjusted basis of $1,024 is $30 for the taxable year, and the amortizable bond premium thereon is $4 for the taxable year, then the $30 is included in gross income, the $4 is allowable as a deduction, the adjusted basis of $1,024 is reduced by $4 to $1,020, and a credit amounting to $0.78 (3 percent of $30 minus $4) is allowed against the tax for such taxable year. In the case of a corporation, which is required to amortize the premium on such bond, no credit is allowed against the tax, but the deduction under section 242 on account of the interest is $26 ($30 minus $4).

(5) In the case where no specific deduction is permitted under section 171 (a) for amortization of bond premium as such, because the tax is computed for the taxpayer under section 3 by use of the optional tax tables, or because the taxpayer elects under section 144 to take the standard deduction, it shall be deemed, if the taxpayer has elected to amortize bond premium in accordance with the provisions of section 171, that the deduction for amortization of bond premium has been allowed for the purpose of determining the adjusted basis of the bond.

(c) *Bonds owned by decedents*—(1) *Decedents using cash receipts and disbursements method of accounting.* (i) Where a decedent who used the cash receipts and disbursements method of accounting owned fully taxable bonds to which section 171 applies—

(*a*) The interest accruing thereon during the period ending with his death is, by reason of section 691, included

thereof in the gross income of

(1) In the case of fully taxable bonds,

amount payable at maturity, regardless of when such bond was acquired by the

in such a manner as to make the entire transaction not bona fide, and hence the

upon its receipt in the gross income of the estate or legatee, whichever acquires the right to receive such interest, and

(*b*) The amount of amortizable bond premium properly allowable for such period is a deduction for such period to the decedent and is not allowable as a deduction to the estate or legatee.

(ii) Where a decedent who used the cash receipts and disbursements method of accounting owned partially tax-exempt bonds to which section 171 applies—

(*a*) The interest accruing thereon during the period ending with his death is, by reason of section 691, included upon its receipt in the gross income of the estate or legatee, whichever acquires the right to receive such interest, and

(*b*) The amount of the amortizable bond premium properly allowable for such period is a deduction for such period to the decedent, as in the case of a fully taxable bond, and

(*c*) The amount of the amortizable bond premium shall not be applied to reduce the estate's or legatee's credit or deduction for such interest for such period.

(2) *Illustration.* The provisions of subparagraph (1) (ii) of this paragraph relating to a partially tax-exempt bond may be illustrated by the following example:

Example. At the time of his death in 1956, D owned a partially tax-exempt bond to which section 171 applies. For the period beginning January 1, 1956, and ending with D's death on September 30, 1956, the accrued interest on such bond is $25 and the amortizable bond premium is $2. D's estate has the right to receive such interest. D's executor, in making the income tax return for D's last taxable year (January 1 to September 30, 1956), may take into account a deduction of $2 on account of the amortizable bond premium for such year. D's estate includes the $25 interest in its gross income upon receipt and, for purposes of the income tax, receives a credit under section 35 of $0.75 (3 percent of $25). In computing such credit, the $25 interest is not reduced on account of the amortizable bond premium which was a deduction allowable for the last taxable year of the decedent.

(3) *Decedents using an accrual method of accounting.* Where a decedent using an accrual method of accounting owned fully taxable bonds and partially tax-exempt bonds to which section 171 applies—

(i) In the case of fully taxable bonds, both the interest accruing thereon during the period ending with his death and the deduction on account of the amortizable bond premium for such period are taken into account in computing the taxable income of the decedent; and

(ii) In the case of partially tax-exempt bonds, the rule as to the accrued interest and the amortization deduction is the same as in subdivision (i) of this subparagraph, and the amount which would otherwise be taken into account in computing the decedent's credit against tax for such interest is required to be reduced by the amount of the amortizable bond premium for the period ending with the decedent's death.

§ 1.171–2 Determination of bond premium.

(a) *In general.* (1) Except as otherwise provided in this section, bond premium on any bond to which section 171 applies is the excess of the amount of the basis (for determining loss on sale or exchange under section 1011) of the bond over the amount payable at maturity or, in the case of a callable bond, the earlier call date. For determination of applicable call date, see paragraph (b) of this section.

(2) (i) In the case of wholly taxable bonds described in section 171 (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, the earlier call date may be used in computing the bond premium only if such earlier call date is a date more than 3 years after the date of original issue. The preceding sentence does not apply to: (*a*) Bonds issued after January 22, 1951, and acquired before January 23, 1954 (for this purpose the date of acquisition shall be considered the date such bonds were ordered under a firm commitment to buy and not the date the bonds were delivered to the taxpayer); or (*b*) bonds issued before January 23, 1951, and acquired at any time. For determining whether an earlier call date is a date more than 3 years after the date of original issue, consideration will be given to the terms under which the bond is issued. Where a bond described in the first sentence of this subdivision is subject to a call date which falls within 3 years of the date of original issue, the amount of amortizable bond premium may be computed only with respect to the amount payable at maturity, regardless of when such bond was acquired by the taxpayer.

(ii) The application of the provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Assume that the taxpayer acquired at the date of issue a $100 bond for $112, callable at any time thereafter upon 30 days' notice. The bond was issued on January 1, 1956. The premium of $12 attributable to such bond may be amortized only with reference to the maturity date of the bond. Similarly, assume that in 1957 the taxpayer acquired a $100, 20-year bond for $115. The bond was issued on January 1, 1954, and was callable 2 years after the date of issuance or, if not then called, 10 years after the date of issuance. The premium of $15 attributable to such bond may be amortized only with reference to the maturity date of the bond.

(iii) In the case of a wholly taxable bond described in section 171 (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue, the amount of the bond premium attributable to the taxable year in which the bond is called shall include an amount equal to the excess of the amount of the adjusted basis (for determining loss on sale or exchange) of such bond as of the beginning of the taxable year over the amount received on redemption of the bond or (if greater) the amount payable on maturity. For adjustments proper to reflect unamortized bond premium for the period before the date as of which section 171 becomes applicable to the bond in the hands of the taxpayer, see subparagraph (4) of this paragraph. For example, if a fully taxable bond, issued on January 1, 1954, and acquired by the taxpayer on January 1, 1955, at a price of $109, matures in 10 years from the date of issue (9 years from the date of acquisition) but is callable at $105 on 30 days' notice, section 171 (b) (1) (B) requires that the bond be amortized to maturity, that is, at the rate of $1 per year. If the bond is called on December 31, 1956, for $105, then $3, the excess of the adjusted basis of $108 ($109 less $1 deducted in 1955) over the amount received on redemption, $105, may be deducted for the year 1956.

(3) Whether the purchase and immediate transfer of callable bonds occurs in such a manner as to make the entire transaction not bona fide, and hence the deductions for amortization for bond premium not allowable, will depend on all the facts and circumstances.

(4) If the date as of which the basis of the bond was established precedes the first taxable year with respect to which section 171 applies to the bond, proper adjustments shall be made to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 1223) before the date as of which section 171 first becomes applicable to the bond in the hands of the taxpayer. Such adjustment is required whether an election was made under section 125 of the Internal Revenue Code of 1939 or under section 171 and applies to all bonds to which section 171 is applicable.

(5) The rule relating to adjustments set forth in subparagraph (4) of this paragraph may be illustrated by the following examples:

Example (*1*). On January 1, 1956, T, who makes his income tax returns on the calendar year basis, owns a fully taxable $100 bond, maturing on January 1, 1966. T purchased this bond on January 1, 1946, for $120. T elects to have section 171 apply to such bond for 1957 and subsequent taxable years. In determining the amount of bond premium to be amortized over the remaining 9 years of the life of the bond, T is required, but solely for such purpose, to treat the bond as if he had amortized the bond premium thereon during the prior 11 years, and to make the proper adjustment in the original bond premium. Accordingly, T would treat $11 as having been amortized during the first 11 years and would be required to amortize the remaining $9 over the following 9 years. When the bond is redeemed on January 1, 1966, for $100, only the $9 attributable to the last 9 years will actually have been amortized and the basis of the bond will have been reduced only by that amount. The $11 attributable to the first 11 years will have been treated as an adjustment to the original bond premium but will not have been amortized nor will the basis of the bond have been reduced by that amount. Consequently, T will have a capital loss in the year of redemption on account of the $11 attributable to the period January 1, 1946, to January 1, 1957.

Example (*2*). On January 1, 1956, X's father gave him a fully taxable $100 bond maturing on January 1, 1966. X's father had purchased the bond on January 1, 1946, for $120. The fair market value of the bond at the time of the gift was $127. X makes his income tax returns on the calendar year

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basis and elects to amortize the bond premium on the bond during the period 1956–1966. Under section 1015, the cost of the bond to X's father constitutes the basis of the bond in X's hands for determining loss, since such cost is lower than the fair market value of the bond at the time of the gift, and, under section 1223, X's holding period is deemed to include the 10 years during which his father held the bond. X is required to treat the bond as if the bond premium thereon had been amortized during his father's holding period. Thus, X is required to amortize $10 over the period January 1, 1956, to January 1, 1966, and in the year of redemption will have a capital loss on account of the $10 attributable to his father's holding period.

Example (3). Y, who makes his income tax returns on the calendar year basis, owns a fully tax-exempt $100 bond maturing on January 1, 1961. He purchased this bond on January 1, 1941, for $120. On December 31, 1954, Y sells the bond for $108 and realizes a gain of $1, computed as follows:

(i) Total bond premium ($120—$100)	$20
(ii) Amount of bond premium amortizable if held to maturity (total bond premium minus unamortized bond premium attributable to 1941 (a year to which section 125 of the Internal Revenue Code of 1939 was not applicable), $20—$1)	19
(iii) Amount of bond premium amortized from Jan. 1, 1942, through Dec. 31, 1954 ($1 for each such year)	13
(iv) Adjusted basis of bond at close of 1954 ($120—$13)	107
(v) Gains ($108–$107)	1

(6) Amortizable bond premium on any bond to which section 171 applies is that part of the bond premium on the bond which is attributable to the taxable year.

(b) *Callable bonds.* (1) For purposes of section 171, in the case of a callable bond, the earlier call date will be considered as the maturity date, except as provided in paragraph (a) (2) and (3) of this section. The amount due on the earlier call date will be considered as the amount payable on maturity unless it is determined under a different method of amortization regularly employed by the taxpayer that another amount shall be the amount payable on maturity. Hence, in the case where a bond premium is to be amortized to the earlier call date, the bond premium on such bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than to the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer.

(2) Where a deduction for amortizable bond premium may be determined with respect to alternative call dates, the amount of amortizable bond premium calculated with reference to a particular call date must be calculated thereafter with reference to the same call date. However, if, upon such call date originally selected, the bond has not in fact been called, the bond premium then unamortized must be amortized to a succeeding call date or to maturity. Thus, assume a $100 bond is acquired at time of issue for $125. The bond is callable in five years at $115 and in 10 years at $110. The taxpayer may amortize $10 of premium during the first five years and, if the bond is not then called, an additional $5 of premium during the next five years. If the bond is not called at the end of ten years, the remaining $10 of premium must be amortized to maturity.

(c) *Convertible bonds.* (1) The fact that a bond is convertible into stock does not, in itself, prevent the application of section 171. A convertible bond is within the scope of such section if the option to convert on a date certain specified in the bond rests with the holder thereof. However, for the purpose of determining the amount of amortizable bond premium on a convertible bond for the taxable year, the amount of bond premium shall not include any amount attributable to the conversion features of the bond. For the purpose of the rule stated in the preceding sentence, the term "convertible bond" includes a bond issued with detachable stock-purchase warrants.

(2) The value of the conversion features of a particular bond shall be ascertained as of the time of acquisition by reference to the assumed price at which such bond would be purchased on the open market if without conversion features, and by subtracting such assumed price from the cost of the bond. The assumed price of the bond without conversion features shall be ascertained by comparison to the yields on which bonds of similar character, not having conversion features, are sold on the open market and adjusting the price of the bond in question to this yield. This adjustment may be made by the use of standard bond tables. In selecting quotations for comparative purposes, bonds of the same classification and grade shall be used.

(3) The application of the principles set forth in this paragraph may be illustrated as follows:

Example. T purchased for $115 a $100 bond, maturing in 10 years, on which interest is payable semiannually at the rate of 3 percent a year. This bond is convertible into common stock at the option of the holder. It is found that bonds of the same character, not having conversion features, were sold on the open market on or about the time of T's purchase on a basis to yield 2.6 percent. By recourse to a standard bond table, it is found that the cost of a 3 percent, 10-year, $100 bond to yield 2.6 percent would have been $103.50. Since the taxpayer paid $115 for the convertible bond, the difference between $115 and $103.50, or $11.50, represents the value of the conversion features of the bond at the time of purchase. The balance of $3.50 represents the bond premium subject to amortization under section 171.

(4) If a convertible bond acquired on or before June 15, 1950, is held during the taxable year, the amortizable bond premium shall be computed as if the provisions for the determination of the bond premium without the inclusion of any amount attributable to the conversion features of the bond were applicable for each year for which the bond was held prior to such taxable year. Thus, if T, in the example in subparagraph (3) of this paragraph, had acquired the bond on January 1, 1949, and if T makes his income tax returns on the basis of the calendar year, the amortizable bond premium for 1957 would be $0.35, determined as follows:

Bond premium not attributable to conversion feature	$3.50
Amortizable bond premium for 1949 and 1950, determined by reference to bond premium not attributable to conversion feature	.70
Portion of bond premium amortizable over remaining life of bond	2.80
Amortizable bond premium for each of the remaining 8 years, including the taxable year 1957 (one-eighth of $2.80)	.35

(d) *Capitalized expenses.* (1) In the case of a bond to which section 171 otherwise applies, on which the bond premium is attributable only to capitalized expenses (such as buying commissions), if a taxpayer—

(i) Regularly employs a reasonable method of amortization under which capitalized expenses are amortized, or

(ii) Is required by the regulations to use the method of amortization prescribed by paragraph (f) of this section, or

(iii) Regularly employs a reasonable method of amortization but does not amortize capitalized expenses,

such taxpayer is permitted, but is not required, to amortize capitalized expenses in accordance with such method.

(2) In the case of a bond to which section 171 applies and on which there is bond premium exclusive of capitalized expenses—

(i) If a taxpayer regularly employs a reasonable method of amortization under which capitalized expenses are treated as being part of the bond premium for purposes of amortization, such capitalized expenses must be treated as being a part of the bond premium for the purposes of section 171.

(ii) If a taxpayer is required by regulations to use the method of amortization prescribed by paragraph (f) of this section, he must treat capitalized expenses as being part of the bond premium for purposes of section 171.

(iii) If a taxpayer regularly employs a method of amortization under which capitalized expenses are not treated as being part of the bond premium for the purposes of amortization, he is permitted, but is not required, to treat such capitalized expenses as being part of the bond premium for the purposes of section 171.

(e) *Taxable years in which interest not received or accruable.* In the case of a taxpayer who makes his income tax returns on the cash receipts and disbursements method or one who makes his returns on an accrual method and who owns a bond to which section 171 applies and in respect of which no interest is received or accrued by the taxpayer during the taxable year, if the taxpayer—

(1) Regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is amortized, or

date, rather than to the maturity date.

(2) Is required by the regulations to use the method of amortization prescribed by paragraph (f) of this section, or

(3) Regularly employs a reasonable method of amortization under which the bond premium on such bond for such taxable year is not amortized,

such taxpayer is permitted, but not required, to amortize bond premium on the bond for such taxable year in accordance with such method.

(f) *Methods of amortization.* (1) Determination of the bond premium and amortizable bond premium on any bond to which section 171 applies shall be made in accordance with:

(i) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(ii) In all other cases, the method of amortization prescribed by this section.

A method of amortization, for example, the composite method described in § 1.1016–9, will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1954, or if for taxable years beginning on or after such date a taxpayer who has never previously taken a deduction for amortization initiates in the first taxable year for which such deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

(2) The bond premium to be amortized shall be determined under the following method:

(i) The amortizable bond premium on such bond attributable to the taxable year under paragraph (a) (6) of this section shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was held by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this subdivision, a fractional part of a month shall be disregarded unless it amounts to more than half of a month, in which case it shall be considered as a month.

(ii) For purposes of subdivision (i) of this subparagraph, the bond premium as of any date on any bond to which section 171 applies shall be determined in accordance with paragraph (a) of this section by ascertaining the excess of the amount of the basis of the bond, as determined under section 1011 (adjusted to date for amortizable bond premium under section 1016) over the amount payable at maturity or, in the case of a callable bond, the earlier call date (except as otherwise provided in paragraph (a) (2) and (3) of this section).

(3) The application of the provisions of this paragraph relating to method of amortization may be illustrated by the following example:

Example. (i) A taxpayer, who makes calendar year returns, on June 20, 1955, acquires at a cost of $119 a $100 bond issued January 1, 1955, maturing January 1, 1965. The amortizable bond premium as of the last day of 1955 is computed as follows:

Bond premium at date of acquisition	$19
Number of months in 1955 during which bond is held by the taxpayer	6
Number of months from date of acquisition to date of maturity	114
Amortizable bond premium ($\frac{6}{114} \times \$19$) equals	1

(ii) The bond premium as of the close of 1955 would be computed as follows:

Bond premium at date of acquisition (or first day of taxable year)	$19
Amortizable bond premium for period during which bond was owned in 1955	1
Bond premium as of the close of the taxable year 1955	18

(iii) If the bond in this example were issued with a call date not more than 3 years after issue date, the premium would also be amortized to maturity as indicated above, because of the application of paragraph (a) (2) of this section.

(4) For the method of amortization in the case of individual mortgages purchased, acquired, or originated at a premium by mutual savings banks, building and loan associations, and cooperative banks, see section 1016 and § 1.1016–9.

§ 1.171–3 Election with respect to taxable and partially taxable bonds.

(a) *In general.* In the case of a corporation, the election provided in section 171 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to the following classes: (1) fully taxable bonds only, or (2) partially tax-exempt bonds only, or (3) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election will be recognized. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all the bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all the bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. In the case of bonds owned by a partnership, common trust fund, or foreign personal holding company, the election shall be exercisable by such partnership (as provided in section 703(b)), common trust fund, or foreign personal holding company.

(b) *Special rule for transition period.* For taxable years beginning after December 31, 1953, and ending after August 16, 1954, the election to deduct amortizable bond premium applies to premiums on both of the following types of bonds:

(1) Those with interest coupons or in registered form, and

(2) Those without interest coupons and not in registered form, including those commonly referred to as "corporate mortgages."

If a taxpayer claimed a deduction for amortizable bond premium in a return filed for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, to which the election under section 171 is applicable to the taxpayer, and such deduction did not include amortizable bond premims for both types of bonds, described in subparagraphs (1) and (2) of this paragraph, held by the taxpayer during such taxable year, such election with respect to the deduction of amortizable bond premiums shall not constitute a valid election unless such election is perfected in accordance with this paragraph in an amended return for such taxable year filed not later than March 11, 1958. Such amended return shall have attached thereto a statement showing a recomputation of the deduction, in accordance with the provisions of section 171 and this section, for amortizable bond premium on both such types of bonds. If such election is not perfected as provided in this paragraph, no deduction shall be allowed for amortization of premium on any bond to which the election is applicable, whether or not with interest coupons or in registered form. If a return has been filed for a subsequent taxable year, such return shall be conformed to the election made with respect to such first taxable year by filing an amended return for such subsequent taxable year, if necessary.

(c) *Partially tax-exempt bonds owned by estates, trusts, partnerships, etc.* If a trust owning partially tax-exempt bonds elects to amortize the bond premium thereon under section 171, the credits of the trust and the credits and deductions of the beneficiaries on account of such interest are required to be reduced by the portion of the amortization deduction attributable to their shares of such interest. See section 642 (a) (1). A similar rule is applicable in the case of partially tax-exempt bonds owned by estates, common trust funds, partnerships, and foreign personal holding companies.

§ 1.171–4 Definition.

(a) The term "bond", as used in section 171, means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), but the term does not include any such obligation which constitutes stock in trade of the

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taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This definition of a bond is applicable to bonds, whether or not with coupons or in registered form, held or acquired in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(b) For taxable years beginning before January 1, 1954, or taxable years beginning after December 31, 1953, but ending on or before August 16, 1954, the term "bond", as defined in paragraph (a) of this section, applies only to a bond, debenture, note, or certificate of other evidence of indebtedness with interest coupons or in registered form.

(c) Section 171 has no application to bonds held by dealers in securities other than bonds held by such dealers for investment pursuant to section 1236 and the regulations thereunder. See, however, § 1.75–1, relating to the treatment of bond premiums in case of dealers in tax-exempt securities.

§ 1.172 Statutory provisions; net operating loss deduction.

SEC. 172. *Net operating loss deduction*—(a) *Deduction allowed.* There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) *Net operating loss carrybacks and carryovers*—(1) *Years to which loss may be carried.* A net operating loss for any taxable year ending after December 31, 1957, shall be—

(A) A net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss, and

(B) A net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(2) *Amount of carrybacks and carryovers.* Except as provided in subsection (i), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the 8 taxable years to which (by reason of subparagraphs (A) and (B) of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other 7 taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) With the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) By determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(c) *Net operating loss defined.* For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) *Modifications.* The modifications referred to in this section are as follows:

(1) *Net operating loss deduction.* No net operating loss deduction shall be allowed.

(2) *Capital gains and losses of taxpayers other than corporations.* In the case of a taxpayer other than a corporation—

(A) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) The deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) *Deduction for personal exemptions.* No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) *Nonbusiness deductions of taxpayers other than corporations.* In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) Any gain or loss from the sale or other disposition of—

(i) Property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) Real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) The modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account; and

(C) Any deduction allowable under section 165(c)(3) (relating to casualty losses) shall not be taken into account.

(5) *Special deductions for corporations.* No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) *Computation of deduction for dividends received, etc.* The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a)(1)(B) of such section.

(e) *Law applicable to computations.* In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) *Taxable years beginning in 1953 and ending in 1954.* In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) That portion of the net operating loss for such year computed without regard to this subsection which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) That portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(3) The net operating loss deduction for such year shall be, in lieu of the amount specified in section 122(c) of the Internal Revenue Code of 1939, the sum of—

(A) That portion of the net operating loss deduction for such year, computed as if subsection (a) of this section were applicable to the taxable year, which the number of days in such year after December 31, 1953, bears to the total number of days in such year, and

(B) That portion of the net operating loss deduction for such year, computed under section 122(c) of the Internal Revenue Code of 1939 as if this paragraph had not been enacted, which the number of days in such year before January 1, 1954, bears to the total number of days in such year.

(4) For purposes of the second sentence of subsection (b)(2), the taxable income for such year shall be the sum of—

(A) That portion of the net income for such year, computed without regard to this paragraph, which the number of days in such year before January 1, 1954, bears to the total number of days in such year, and

(B) That portion of the net income for such year, computed—

(i) Without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) By allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code,

which the number of days in such year after December 31, 1953, bears to the total number of days in such year.

(g) *Special transitional rules*—(1) *Losses for taxable years ending before January 1, 1954.* For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) *Losses for taxable years ending after December 31, 1953.* For purposes of section 122 of the Internal Revenue Code of 1939—

(A) The determination of the taxable years ending before January 1, 1954, to which a net operating loss for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b)(1)(A) of this section; and

(B) In determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) The net income for the second preceding taxable year computed as if the second sentence of section 122(b)(2)(B) of the Internal Revenue Code of 1939 applied, or

(ii) If smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) *Taxable years beginning after December 31, 1953, and ending before August 17, 1954.* In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954—

(A) The net operating loss deduction for such year shall be computed as if subsec-

tion (a) of this section applied to such taxable year, and

(B) For purposes of the second sentence of subsection (b)(2), the taxable income for such taxable year shall be the net income for such taxable year, computed—

(i) Without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) By allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code.

(4) *Excess profits tax not affected.* For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) *Disallowance of net operating loss of electing small business corporations.* In determining the amount of the net operating loss deduction under subsection (a) of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S.

(i) *Carryback of net operating loss for taxable years beginning in 1957 and ending in 1958.* In the case of a taxable year beginning in 1957 and ending in 1958, the amount of any net operating loss for such year which shall be carried to the third preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1957, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the third taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the third preceding taxable year.

(j) *Cross references.* (1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

[Sec. 172 as amended by secs. 14 and 64(b), Technical Amendments Act 1958 (72 Stat. 1611, 1656); sec. 203, Small Business Tax Revision Act 1958 (72 Stat. 1678)]

§ 1.172–1 Net operating loss deduction.

(a) *Allowance of deduction.* Section 172(a) allows as a deduction in computing taxable income for any taxable year subject to the Code the aggregate of the net operating loss carryovers and net operating loss carrybacks to such taxable year. This deduction is referred to as the net operating loss deduction. The net operating loss is the basis for the computation of the net operating loss carryovers and net operating loss carrybacks and ultimately for the net operating loss deduction itself. The net operating loss deduction shall not be disallowed for any taxable year merely because the taxpayer has no income from a trade or business for the taxable year.

(b) *Steps in computation of net operating loss deduction.* The three steps to be taken in the ascertainment of the net operating loss deduction for any taxable year subject to the Code are as follows:

(1) Compute the net operating loss for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to such taxable year.

(2) Compute the net operating loss carryovers to such taxable year from such preceding taxable years and the net operating loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such net operating loss carryovers and carrybacks in order to determine the net operating loss deduction for such taxable year.

(c) *Statement with tax return.* Every taxpayer claiming a net operating loss deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction.

(d) *Ascertainment of deduction dependent upon net operating loss carryback.* If the taxpayer is entitled in computing his net operating loss deduction to a carryback which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on his return without regard to such net operating loss carryback. When the taxpayer ascertains the net operating loss carryback, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carryback; or he may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations*—(1) *General.* The following rules shall apply to all taxable years without regard to whether they began before, on, or after January 1, 1954:

(i) In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(ii) The net operating loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the net operating loss deduction. In applying this rule, however, certain taxable years subject to the Internal Revenue Code of 1939 shall, to the extent provided in paragraphs (a) and (c) of § 1.172–2 and paragraphs (a) and (e) of § 1.172–3, be treated as though subject to the Internal Revenue Code of 1954.

(iii) The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year.

(2) *Special transitional rules.* See section 172(g) for special transitional rules with respect to (i) net operating losses sustained in taxable years ending before January 1, 1954, (ii) net operating losses sustained in taxable years ending after December 31, 1953, and (iii) the net operating loss deduction for taxable years beginning after December 31, 1953, and ending before August 17, 1954.

(f) *Taxable years subject to the Internal Revenue Code of 1939*—(1) *In general.* For the computation of the net operating loss deduction for any taxable year (other than the taxable years described in subparagraphs (2) and (3) of this paragraph) which is subject to the Internal Revenue Code of 1939, see 26 CFR (1939) § 39.122–5 (Regulations 118) or the corresponding section of prior applicable regulations.

(2) *Taxable years beginning in 1953 and ending in 1954.* The net operating loss deduction for a taxable year beginning in 1953 and ending in 1954, shall be, in lieu of the amount specified in section 122(c) of the Internal Revenue Code of 1939 and in 26 CFR (1939) § 39.122–5 (Regulations 118), the sum of—

(i) That portion of the net operating loss deduction for such taxable year, computed in accordance with paragraph (b) of this section as though section 172(a) of the Internal Revenue Code of 1954 applied to such taxable year, which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such taxable year, and

(ii) That portion of the net operating loss deduction for such taxable year, computed in accordance with section 122(c) of the Internal Revenue Code of 1939 and as though section 172(f)(3) of the Internal Revenue Code of 1954 had not been enacted, which the number of days in such taxable year before January 1, 1954, bears to the total number of days in such taxable year.

(3) *Taxable years beginning after December 31, 1953, and ending before August 17, 1954.* In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954, the net operating loss deduction shall be computed in accordance with paragraph (b) of this section as though section 172(a) of the Internal Revenue Code of 1954 applied to such taxable year.

(4) *Statute of limitations, etc.; interest.* If a refund or credit of any overpayment resulting from the application of subparagraph (2) or (3) of this paragraph is prevented on September 2, 1958, or within six months after such date, by the operation of any law or rule of law other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed on or before March 2, 1959. No interest shall be paid or allowed on any overpayment resulting from the application of subparagraph (2) or (3) of this paragraph. See section 14(c) of the Technical Amendments Act of 1958 (72 Stat. 1611).

(g) *Electing small business corporations.* In determining the amount of the net operating loss deduction of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation was an electing small business corporation under subchapter S (section 1371 and following), chapter 1 of the Code. In applying section 172(b)

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(1) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as determined under section 172 (b) (2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation. See section 1374 and the regulations thereunder for allowance of a deduction to shareholders for a net operating loss sustained by an electing small business corporation.

(h) *Husband and wife.* The net operating loss deduction of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of § 1.172–7.

§ 1.172–2 Net operating loss in case of a corporation.

(a) *Modification of deductions.* A net operating loss is sustained by a corporation in any taxable year beginning after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code of 1954 over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the Internal Revenue Code of 1939. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.* No deduction shall be allowed under—

(i) Section 172 for the net operating loss deduction,

(ii) Section 242 in respect of partially tax-exempt interest, and

(iii) Section 922 in respect of Western Hemisphere trade corporations;

(2) *Dividends received.* The 85-percent limitation provided by section 246 (b) shall not apply to the deductions otherwise allowed under—

(i) Section 243(a) in respect of dividends received from domestic corporations,

(ii) Section 244 in respect of dividends received on preferred stock of public utilities, and

(iii) Section 245 in respect of dividends received from foreign corporations; and

(3) *Dividends paid.* The deduction granted by section 247 in respect of dividends paid on the preferred stock of public utilities shall be computed without regard to subsection (a) (1) (B) of that section.

(b) *Illustration of principles.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. For the calendar year 1954 the X Corporation has gross income of $400,000 and total deductions allowed by chapter 1 of the 1954 Code of $375,000, exclusive of any net operating loss deduction and exclusive of any deduction for dividends received or paid. Corporation X in 1954 received $100,000 of dividends entitled to the benefits of section 243(a). These dividends are included in Corporation X's $400,000 gross income. Corporation X likewise received $50,000 of partially tax-exempt interest in 1954 for which a deduction is allowed under section 242. This interest is included in both the $400,000 gross income and the $375,000 total deductions. Corporation X has no other deductions to which section 172 (d) applies. On the basis of these facts, Corporation X has a net operating loss for the year 1954 of $10,000, computed as follows:

Deductions for 1954	$375,000
Plus: Deduction for dividends received, computed without regard to the limitation provided in section 246 (b) (85% of $100,000)	85,000
Total	460,000
Less: Deduction with respect to partially tax-exempt interest	50,000
Deductions modified as required by section 172 (d)	410,000
Less: Gross income for 1954 (including $100,000 dividends and $50,000 partially tax-exempt interest)	400,000
Net operating loss for 1954	10,000

(c) *Taxable years beginning in 1953 and ending in 1954.* The net operating loss of a corporation for a taxable year which begins in 1953 and ends in 1954 shall be the sum of—

(1) *Application of Internal Revenue Code of 1954.* That portion of the net operating loss for the taxable year, computed in accordance with paragraph (a) of this section as though such taxable year began after December 31, 1953, which the number of days in the taxable year after December 31, 1953, bears to the total number of days in the taxable year, and

(2) *Application of Internal Revenue Code of 1939.* That portion of the net operating loss for the taxable year, computed in accordance with section 122 of the Internal Revenue Code of 1939 and as though section 172 of the Internal Revenue Code of 1954 had not been enacted, which the number of days in the taxable year before January 1, 1954, bears to the total number of days in the taxable year.

(d) *Excess profits tax.* For the computation of the net operating loss for purposes of determining the excess profits tax imposed by subchapter D of chapter 1 of the Internal Revenue Code of 1939, see § 1.172–8.

§ 1.172–3 Net operating loss in case of a taxpayer other than a corporation.

(a) *Modification of deductions.* A net operating loss is sustained by a taxpayer other than a corporation in any taxable year beginning after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code of 1954 over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the Internal Revenue Code of 1939. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.* No deduction shall be allowed under—

(i) Section 151 for the personal exemptions or under any other section which grants a deduction in lieu of the deductions allowed by section 151,

(ii) Section 172 for the net operating loss deduction, and

(iii) Section 1202 in respect of the net long-term capital gain.

(2) *Capital losses.* (i) The amount deductible on account of business capital losses shall not exceed the sum of the amount includible on account of business capital gains and that portion of nonbusiness capital gains which is computed in accordance with paragraph (c) of this section.

(ii) The amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains.

(3) *Nonbusiness deductions*—(i) *Ordinary deductions.* Ordinary nonbusiness deductions shall be taken into account without regard to the amount of business deductions and shall be allowed in full to the extent, but not in excess, of that amount which is the sum of the ordinary nonbusiness gross income and the excess of nonbusiness capital gains over nonbusiness capital losses. See paragraph (c) of this section. For purposes of section 172, nonbusiness deductions and income are those deductions and that income which are not attributable to, or derived from, a taxpayer's trade or business. Wages and salary constitute income attributable to the taxpayer's trade or business for such purposes.

(ii) *Sale of business property.* Any gain or loss on the sale or other disposition of property which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposes of section 172 (d) (4), as attributable to, or derived from, the taxpayer's trade or business. Such gains and losses are to be taken into account fully in computing a net operating loss without regard to the limitation on nonbusiness deductions. Thus, a farmer who sells at a loss land used in the business of farming may, in computing a net operating loss, include in full the deduction otherwise allowable with respect to such loss, without regard to the amount of his nonbusiness income and without regard to whether he is engaged in the trade or business of selling farms. Similarly, an individual who sells at a loss machinery which is used in his trade or business and which is of a character that is subject to the allowance for depreciation may, in computing the net operating loss, include in full the deduction otherwise allowable with respect to such loss.

(iii) *Casualty losses.* Any deduction allowable under section 165 (c) (3) for losses of property not connected with a trade or business shall not be considered, for purposes of section 172 (d) (4), to be a nonbusiness deduction but shall be treated as a deduction attributable to the taxpayer's trade or business.

(iv) *Limitation.* The provisions of this subparagraph shall not be construed to permit the deduction of items disallowed by subparagraph (1) of this paragraph.

(b) *Treatment of capital loss carryovers.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has a capital loss carryover from preceding taxable years, includible by virtue of section 1212 among the short-term capital losses for the taxable year in issue, is required to determine how much of such capital loss carryover is a business capital loss and how much is a nonbusiness capital loss. In order to make this determination, the taxpayer shall first ascertain what proportion of the net capital loss for each of such preceding taxable years was attributable to an excess of business capital losses over business capital gains for such year, and what proportion was attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. The same proportion of the capital loss carryover from any such preceding taxable year shall be treated as a business capital loss and a nonbusiness capital loss, respectively. This rule may be illustrated by the following example:

Example. (1) A, an individual, has $5,000 ordinary taxable income (computed without regard to the deductions for personal exemptions) for the calendar year 1954 and also has the following capital gains and losses for such year: Business capital gains of $2,000; business capital losses of $3,200; nonbusiness capital gains of $1,000; and nonbusiness capital losses of $1,200.

(2) A's net capital loss for the taxable year 1954 is $400, computed as follows:

Capital losses	$4,400
Capital gains	3,000
Excess of capital losses over capital gains	1,400
Less: $1,000 of such ordinary taxable income	1,000
Net capital loss for 1954	400

(3) A's capital losses for 1954 exceeded his capital gains for such year by $1,400. Since A's business capital losses for 1954 exceeded his business capital gains for such year by $1,200, 6/7ths ($1,200/$1,400) of A's net capital loss for 1954 is attributable to an excess of his business capital losses over his business capital gains for such year. Similarly, 1/7th of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the capital loss carryover from 1954 to 1955 is $400, 6/7ths of $400, or $342.86, shall be treated as a business capital loss in 1955; and 1/7th of $400, or $57.14, as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses.* In the computation of a net operating loss a taxpayer other than a corporation must use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. Any amount not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. The remainder, computed by applying the excess ordinary nonbusiness deductions against the excess nonbusiness capital gains, shall be treated as nonbusiness capital gains and used for the purpose of determining the deductibility of business capital losses under paragraph (a) (2) (i) of this section. This principle may be illustrated by the following example:

Example. (1) A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Capital gains	13,000
Total gross income	20,500

(2) A also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Capital loss	7,000
Total deductions	16,000

(3) The portion of nonbusiness capital gains to be used for the purpose of determining the deductibility of business capital losses is $4,500, computed as follows:

Nonbusiness capital gains		$13,000
Less: Nonbusiness capital loss		7,000
Excess to be taken into account for purposes of paragraph (a) (3) (i) of this section		6,000
Ordinary nonbusiness deductions	$9,000	
Less: Ordinary nonbusiness gross income	7,500	
		1,500
Portion of nonbusiness capital gains to be used for purposes of paragraph (a) (2) (i) of this section		4,500

(d) *Joint net operating loss of husband and wife.* In the case of a husband and wife, the joint net operating loss for any taxable year for which a joint return is filed is to be computed on the basis of the combined income and deductions of both spouses, and the modifications prescribed in paragraph (a) of this section are to be computed as if the combined income and deductions of both spouses were the income and deductions of one individual.

(e) *Taxable years beginning in 1953 and ending in 1954.* The net operating loss of a taxpayer other than a corporation for a taxable year which begins in 1953 and ends in 1954 shall be the sum of—

(1) *Application of Internal Revenue Code of 1954.* That portion of the net operating loss for the taxable year, computed in accordance with paragraph (a) of this section as though such taxable year began after December 31, 1953, which the number of days in the taxable year after December 31, 1953, bears to the total number of days in the taxable year, and

(2) *Application of Internal Revenue Code of 1939.* That portion of the net operating loss for the taxable year, computed in accordance with section 122 of the Internal Revenue Code of 1939 and as though section 172 of the Internal Revenue code of 1954 had not been enacted, which the number of days in the taxable year before January 1, 1954, bears to the total number of days in the taxable year.

(f) *Illustration of computation of net operating loss of a taxpayer other than a corporation*—(1) *Facts.* For the calendar year 1954 A, an individual, has gross income of $483,000 and allowable deductions of $540,000. The latter amount does not include the net operating loss deduction or any deduction on account of the sale or exchange of capital assets. Included in gross income are business capital gains of $50,000 and ordinary nonbusiness income of $10,000. Included among the deductions are ordinary nonbusiness deductions of $12,000 and a deduction of $600 for his personal exemption. A has a business capital loss of $60,000 in 1954. A has no other items of income or deductions to which section 172 (d) applies.

(2) *Computation.* On the basis of these facts, A has a net operating loss for 1954 of $104,400, computed as follows:

Deductions for 1954 (as specified in first sentence of subparagraph (1))		$540,000
Plus: Amount of business capital loss ($60,000) to extent such amount does not exceed business capital gains ($50,000)		50,000
Total		590,000
Less: Excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income ($12,000 minus $10,000)	$2,000	
Deduction for personal exemption	600	
		$2,600
Deductions for 1954 adjusted as required by section 172 (d)		587,400
Gross income for 1954		483,000
Net operating loss for 1954		104,400

§ 1.172–4 Net operating loss carrybacks and net operating loss carryovers.

(a) *General provisions*—(1) *Years to which loss may be carried*—(i) *In general.* In order to compute the net operating loss deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue.

(ii) *Loss for taxable years ending after December 31, 1957.* A net operating loss sustained in a taxable year ending after December 31, 1957, shall be carried back to the three preceding taxable years and carried over to the five succeeding taxable years.

(iii) *Loss for taxable years ending after December 31, 1953, and before January 1, 1958.* A net operating loss sustained in a taxable year ending after December 31, 1953, and before January 1, 1958, shall be carried back to the two preceding taxable years and carried over to the five succeeding taxable years; this rule shall apply even though the loss year is otherwise subject to the Internal Revenue Code of 1939.

(iv) *Loss for taxable years beginning after December 31, 1949, and ending before January 1, 1954.* A net operating loss sustained in a taxable year beginning after December 31, 1949, and ending before January 1, 1954, shall be carried back to the first preceding taxable year and carried over to the five succeeding taxable years.

(2) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441 (b) and 7701 (a) (23) is a preceding or a succeeding taxable year for the purpose of determining under section 172 the first, second, etc., preceding or succeeding taxable year.

(3) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(4) *Husband and wife.* The net operating loss carryovers and carrybacks of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of § 1.172–7.

(5) *Excess profits tax.* For the number of taxable years to which a net operating loss may be carried back for the purpose of determining the excess profits tax imposed by subchapter D of chapter 1 of the Internal Revenue Code of 1939, see § 1.172–8.

(6) *Corporate acquisitions.* For the computation of the net operating loss carryovers in the case of certain acquisitions of the assets of a corporation by another corporation, see section 381 and the regulations thereunder.

(7) *Special limitations.* For special limitations on the net operating loss carryovers in certain cases of change in both the ownership and the trade or business of a corporation and in certain cases of corporate reorganization lacking specified continuity of ownership, see section 382 and the regulations thereunder.

(8) *Electing small business corporations.* For special rule applicable to corporations which were electing small business corporations under subchapter S (section 1371 and following), chapter 1 of the Code, during one or more of the taxable years described in section 172 (b) (1), see paragraph (g) of § 1.172–1.

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) A net operating loss shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc. The entire net operating loss shall be carried back to such earliest year.

(ii) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the aggregate of the taxable incomes (computed as provided in § 1.172–5) for all of such several taxable years preceding such subsequent taxable year which are subject to the Internal Revenue Code of 1954 and the aggregate of the net incomes (computed as provided in 26 C.F.R. (1939) 39.122–4(c) (Regulations 118) or in the corresponding section of prior applicable regulations) for all of such preceding taxable years which are subject to the Internal Revenue Code of 1939.

(2) *Taxable years beginning in 1953 and ending in 1954.* (i) Notwithstanding subparagraph (1) of this paragraph, in the case of a net operating loss sustained in a taxable year which begins in 1953 and ends in 1954, the amount of such loss which shall be carried back to the second preceding taxable year is the amount which bears the same ratio to such net operating loss (computed as provided in § 1.172–2 (c) or § 1.172–3 (e), whichever applies) as the number of days in such loss year after December 31, 1953, bears to the total number of days in such year.

(ii) To determine the portion of the net operating loss for such a taxable year ending in 1954 which shall be carried to any taxable year subsequent to such second preceding taxable year there shall be substituted, in the application of subparagraph (1) (ii) of this paragraph, for the net income of such second preceding taxable year an amount equal to the portion of the net operating loss which is carried back to such second preceding taxable year in accordance with this subparagraph, if such amount is smaller than the net income of such second preceding taxable year as computed under 26 CFR (1939) 29.122–4(c) (Regulations 111).

(3) *Taxable years beginning in 1957 and ending in 1958.* (i) Notwithstanding subparagraph (1) of this paragraph, in the case of a net operating loss sustained in a taxable year which begins in 1957 and ends in 1958, the amount of such loss which shall be carried back to the third preceding taxable year is the amount which bears the same ratio to such net operating loss (as determined under section 172(c)) as the number of days in the loss year after December 31, 1957, bears to the total number of days in such year.

(ii) To determine the portion of the net operating loss for such a taxable year ending in 1958 which shall be carried to any taxable year subsequent to such third preceding taxable year there shall be substituted, in the application of subparagraph (1) (ii) of this paragraph, for the taxable income of such third preceding taxable year an amount equal to the portion of the net operating loss which is carried back to such third preceding taxable year in accordance with this subparagraph, if such amount is smaller than the taxable income of such third preceding taxable year as computed under paragraph (a) of § 1.172–5.

(4) *Excess profits tax.* For the portion of a net operating loss which may be carried back from a taxable year ending after December 31, 1953, for the purpose of determining the excess profits tax imposed by subchapter D, chapter 1 of the Internal Revenue Code of 1939, see § 1.172–8.

(5) *Illustration of principles.* The application of this paragraph may be illustrated by the following examples:

Example (1). A taxpayer who makes his tax returns on the calendar-year basis has a net operating loss for 1954. The entire net operating loss for 1954 may be carried back to 1952. The amount of the carryback to 1953 is the excess of the 1954 loss over the net income for 1952. The amount of the carryover to 1955 is the excess of the 1954 loss over the aggregate of the net incomes for 1952 and 1953. The amount of the carryover to 1956 is the excess of the 1954 loss over the sum of the aggregate of the net incomes for 1952 and 1953 and the taxable income for 1955. Similarly, the amount of the carryovers to 1957, 1958, and 1959 is the excess of the 1954 loss over the sum of the aggregate of the net incomes for 1952 and 1953 and the aggregate of the taxable incomes for 1955 and 1956; for 1955, 1956, and 1957; and for 1955, 1956, 1957, and 1958, respectively. For such purposes, the net incomes for 1952 and 1953 shall be computed as provided in 26 CFR (1939) 39.122–4(c) (Regulations 118), and the taxable incomes for 1955 through 1958 shall be computed as provided in § 1.172–5.

Example (2). (i) A taxpayer who makes his tax returns on the basis of a fiscal year ending June 30 has a net operating loss (computed as provided in section 172(c)) for the taxable year which begins July 1, 1957, and ends June 30, 1958. The amount of the carryback from such taxable year to the taxable year ending June 30, 1955, the third preceding taxable year, is 181/365ths of the net operating loss. If such amount is not less than the taxable income (computed as provided in § 1.172–5) for the taxable year ending June 30, 1955, the amount of the carryback to the taxable year ending June 30, 1956, is the excess of the net operating loss over the taxable income so computed for the taxable year ending June 30, 1955; and the amount of the carryback to the taxable year ending June 30, 1957, is the excess of the net operating loss over the aggregate of the taxable incomes so computed for the taxable years ending June 30, 1955, and 1956. The amount of the carryovers to the taxable years ending June 30, 1959, 1960, 1961, 1962, and 1963 is the excess of the net operating loss over the aggregate of the taxable incomes (computed as provided in § 1.172–5) for the taxable years ending June 30, 1955, 1956, and 1957; 1955, 1956, 1957, and 1959; 1955, 1956, 1957, 1959, and 1960; 1955, 1956, 1957, 1959, 1960, and 1961; and 1955, 1956, 1957, 1959, 1960, 1961, and 1962, respectively.

(ii) If, however, the taxable income (computed as provided in § 1.172–5) for the taxable year ending June 30, 1955, exceeds the amount of the carryback to such taxable year (181/365ths of the net operating loss for the loss year), then the amount of the carryback to the taxable year ending June 30, 1956, is the excess of the net operating loss over the amount of the carryback to the taxable year ending June 30, 1955. The amount of the carryback to the taxable year ending June 30, 1957, is the excess of the net operating loss over the sum of the amount of the carryback to the taxable year ending June 30, 1955, and the taxable income (computed as provided in § 1.172–5) for the taxable year ending June 30, 1956. The amount of the carryovers to the taxable years ending June 30, 1959, 1960, 1961, 1962, and 1963 is the excess of the net operating loss over the sum of the amount of the carryback to the taxable year ending June 30, 1955, and the aggregate of the taxable incomes (computed as provided in § 1.172–5) for the taxable years ending June 30, 1956, and 1957; 1956, 1957, and 1959; 1956, 1957, 1959, and 1960; 1956, 1957, 1959, 1960, and 1961; and 1956, 1957, 1959, 1960, 1961, and 1962, respectively.

(c) *Illustration.* The principles of this section are illustrated in § 1.172–6.

§ 1.172–5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) *Taxable year subject to the Internal Revenue Code of 1954.* The taxable income for any taxable year subject to the Internal Revenue Code of 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year is computed with the modifications prescribed in this paragraph. These modifications shall be made independently of, and without reference to, the modifications required by §§ 1.172–2 (a) and 1.172–3 (a) for purposes of computing the net operating loss itself.

(1) *Modifications applicable to corporations only.* In the case of a corporation the deductions provided by section 242 (relating to partially tax-exempt interest) and by section 922 (relating to Western Hemisphere trade corporations) shall not be allowed.

(2) *Modifications applicable to unincorporated taxpayers only.* In the case of a taxpayer other than a corporation, in computing taxable income and adjusted gross income—

(i) No deduction shall be allowed under section 151 for the personal exemptions (or under any other section which grants a deduction in lieu of the deductions allowed by section 151) and under section 1202 in respect of the net long-term capital gain.

(ii) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets.

(3) *Modifications applicable to all taxpayers.* In the case either of a corporation or of a taxpayer other than a corporation—

(i) *Net operating loss deduction.* The net operating loss deduction for such taxable year shall be computed by taking into account only such net operating losses otherwise allowable as carryovers or a carryback to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the taxable income is to be deducted. Thus, for such purposes, the net operating loss for the loss year or for any taxable year thereafter shall not be taken into account.

Example. The taxpayer's income tax returns are made on the basis of the calendar year. In computing the net operating loss deduction for 1954, the taxpayer has a carryover from 1952 of $9,000, a carryover from 1953 of $6,000, a carryback from 1955 of $18,000, and a carryback from 1956 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the net operating loss deduction for 1954, for purposes of determining the tax liability for 1954, is $43,000. However, in computing the taxable income for 1954 which is subtracted from the net operating loss for 1955 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $15,000, that is, the aggregate of the $9,000 carryover from 1952 and the $6,000 carryover from 1953. In computing the net operating loss deduction for such purpose, the $18,000 carryback from 1955 and the $10,000 carryback from 1956 are disregarded. In computing the taxable income for 1954, however, which is subtracted from the net operating loss for 1956 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $33,000, that is, the aggregate of the $9,000 carryover from 1952, the $6,000 carryover from 1953, and the $18,000 carryback from 1955. In computing the net operating loss deduction for such purpose, the $10,000 carryback from 1956 is disregarded.

(ii) *Recomputation of percentage limitations.* Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the taxable income or adjusted gross income, as the case may be, determined with the modifications prescribed in this paragraph. Thus, in the case of an individual the deduction for medical expenses would be recomputed after making all the modifications prescribed in this paragraph, whereas the deduction for charitable contributions would be determined without regard to any net operating loss carryback but with regard to any other modifications so prescribed.

Example (1). For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $4,800, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income)	200	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income)	1,400	
		2,200
Taxable income		4,800

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957 the taxable income for 1954 as computed under this paragraph is $3,970, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		6,000
Less:		
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income as modified under this paragraph)	$230	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income determined with all the modifications prescribed in this paragraph other than the net operating loss carryback)	1,800	
		2,030
Taxable income		3,970

Example (2). For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $5,700, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Standard deduction allowed by section 141	700	
		1,300
Taxable income		5,700

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957 the taxable income for 1954 as computed under this paragraph is $5,400, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		6,000
Less: Standard deduction allowed by section 141		600
Taxable income		5,400

(iii) *Minimum limitation.* The taxable income, as modified under this paragraph, shall in no case be considered less than zero.

(4) *Electing small business corporations.* For special rule applicable to corporations which were electing small business corporations under subchapter S (section 1371 and following), chapter 1 of the Code, during one or more of the taxable years described in section 172 (b) (1), see paragraph (g) of § 1.172–1.

(b) *Taxable year subject to 1939 Code*—(1) *In general.* For the computation of the net income for any taxable year (other than the taxable years described in subparagraphs (2) and (3) of this paragraph) subject to the 1939 Code which is subtracted from the net operating loss for any other taxable

year to determine the portion of such loss which is a carryback or a carryover to a particular taxable year, see 26 CFR (1939) § 39.122–4(c) (Regulations 118) or the corresponding section of prior applicable regulations.

(2) *Taxable years beginning in 1953 and ending in 1954.* The net income for any taxable year beginning in 1953 and ending in 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year shall be the sum of—

(i) That portion of the net income for such taxable year, computed as provided in clauses (i) and (ii) of the first sentence of section 122(b)(2)(B) of the Internal Revenue Code of 1939, which the number of days in such taxable year before January 1, 1954, bears to the total number of days in such taxable year, and

(ii) That portion of the net income for such taxable year, computed—

(*a*) As provided in clauses (i) and (ii) of the first sentence of section 122(b)(2)(B) of the Internal Revenue Code of 1939 but without regard to the modifications provided in section 122(d) (1) and (2) of such Code, and

(*b*) By allowing as a deduction an amount equal to the sum of the credits allowable for such taxable year under section 26(b) (relating to credit for dividends received) and section 26(h) (relating to credit for dividends paid on certain preferred stock) of the Internal Revenue Code of 1939 in determining normal-tax net income,

which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such taxable year.

(3) *Taxable years beginning after December 31, 1953, and ending before August 17, 1954.* The net income for any taxable year beginning after December 31, 1953, and ending before August 17, 1954, which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year shall be the net income for such taxable year, computed—

(i) As provided in clauses (i) and (ii) of the first sentence of section 122(b)(2)(B) of the Internal Revenue Code of 1939 but without regard to the modifications provided in section 122(d) (1) and (2) of such Code, and

(ii) By allowing as a deduction an amount equal to the sum of the credits allowable for such taxable year under section 26(b) (relating to the credit for dividends received) and section 26(h) (relating to the credit for dividends paid on certain preferred stock) of the Internal Revenue Code of 1939 in determining normal-tax net income.

(4) *Statute of limitations, etc.; interest.* If a refund or credit of any overpayment resulting from the application of subparagraph (2) or (3) of this paragraph is prevented on September 2, 1958, or within six months after such date, by the operation of any law or rule of law other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed on or before March 2, 1959. No interest shall be paid or allowed on any overpayment resulting from the application of subparagraph (2) or (3) of this paragraph. See section 14(c) of the Technical Amendments Act of 1958 (72 Stat. 1611).

§ 1.172–6 Illustration of net operating loss carrybacks and carryovers.

The application of § 1.172–4 may be illustrated by the following example:

(*a*) *Facts.* The books of the taxpayer, whose return is made on the basis of the calendar year, reveal the following facts:

Taxable year	*Taxable income*	*Net operating loss*
1954	$15,000	-------
1955	30,000	-------
1956	-------	($75,000)
1957	20,000	-------
1958	-------	(150,000)
1959	30,000	-------
1960	35,000	-------
1961	75,000	-------
1962	17,000	-------
1963	53,000	-------

The taxable income thus shown is computed without any net operating loss deduction. The assumption is also made that none of the other modifications prescribed in § 1.172–5 apply. There are no net operating losses for 1950, 1951, 1952, 1953, 1964, 1965, or 1966.

(*b*) *Loss sustained in 1956.* The portions of the $75,000 net operating loss for 1956 which shall be used as carrybacks to 1954 and 1955 and as carryovers to 1957, 1958, 1959, 1960, and 1961 are computed as follows:

(1) *Carryback to 1954.* The carryback to this year is $75,000, that is, the amount of the net operating loss.

(2) *Carryback to 1955.* The carryback to this year is $60,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	15,000	
Carryback		60,000

(3) *Carryover to 1957.* The carryover to this year is $30,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
		45,000
Carryover		30,000

(4) *Carryover to 1958.* The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
		65,000
Carryover		10,000

(5) *Carryover to 1959.* The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
		65,000
Carryover		10,000

(6) *Carryover to 1960.* The carryover to this year is $0, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
Taxable income for 1959 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	30,000	
		95,000
Carryover		0

(7) *Carryover to 1961.* The carryover to this year is $0, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	

Less—Continued

Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	$30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
Taxable income for 1959 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	30,000	
Taxable income for 1960 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	35,000	
		$130,000
Carryover		0

(c) *Loss sustained in 1958.* The portions of the $150,000 net operating loss for 1958 which shall be used as carrybacks to 1955, 1956, and 1957 and as carryovers to 1959, 1960, 1961, 1962, and 1963 are computed as follows:

(1) *Carryback to 1955.* The carryback to this year is $150,000, that is, the amount of the net operating loss.

(2) *Carryback to 1956.* The carryback to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Carryback		150,000

(3) *Carryback to 1957.* The carryback to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	$0	

Less—Continued

Taxable income for 1956 (a year in which a net operating loss was sustained)	$0	
		$0
Carryback		150,000

(4) *Carryover to 1959.* The carryover to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	$0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
		0
Carryover		150,000

(5) *Carryover to 1960.* The carryover to this year is $130,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	$0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	

Less—Continued

Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
		$20,000
Carryover		130,000

(6) *Carryover to 1961.* The carryover to this year is $95,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	$0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
		55,000
Carryover		95,000

(7) *Carryover to 1962.* The carryover to this year is $20,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	$0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
Taxable income for 1961 (the $75,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1961 not being taken into account)	75,000	
		130,000
Carryover		20,000

(8) *Carryover to 1963.* The carryover to this year is $3,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	$0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
Taxable income for 1961 (the $75,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1961 not being taken into account)	75,000	
Taxable income for 1962 (computed without the deduction of the carryover from 1958)	17,000	
		147,000
Carryover		3,000

(d) *Determination of net operating loss deduction for each year.* The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the net operating loss deduction in the following manner:

Taxable year	Carryover		Carryback		Net operating loss deduction
	From 1956	From 1958	From 1956	From 1958	
1954			$75,000		$75,000
1955			60,000	$150,000	210,000
1957	$30,000			150,000	180,000
1959	10,000	$150,000			160,000
1960		130,000			130,000
1961		95,000			95,000
1962		20,000			20,000
1963		3,000			3,000

§ 1.172–7 Joint return by husband and wife.

(a) *In general.* This section prescribes additional rules for computing the net operating loss carrybacks and carryovers of a husband and wife making a joint return for one or more of the taxable years involved in the computation of the net operating loss deduction. If any one or more of the taxable years involved in the computation of such net operating loss carrybacks and carryovers is a taxable year subject to the Internal Revenue Code of 1939, see also 26 CFR (1939) 39.122–4(e) (Regulations 118) or the corresponding section of prior applicable regulations.

(b) *From separate to joint return.* If a husband and wife, making a joint return for any taxable year, did not make a joint return for any of the taxable years involved in the computation of a net operating loss carryover or a net operating loss carryback to the taxable year for which the joint return is made, such separate net operating loss carryover or separate net operating loss carryback is a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(c) *Continuous use of joint return.* If a husband and wife making a joint return for a taxable year made a joint return for each of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the joint net operating loss carryover or joint net operating loss carryback to such taxable year is computed in the same manner as the net operating loss carryover or net operating loss carryback of an individual under § 1.172–4 but upon the basis of the joint net operating losses and the combined taxable income of both spouses.

(d) *From joint to separate return.* If a husband and wife making separate returns for a taxable year made a joint return for any, or all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the separate net operating loss carryover or separate net operating loss carryback of each spouse to the taxable year is computed in the manner set forth in § 1.172–4 but with the following modifications:

(1) *Net operating loss.* The net operating loss of each spouse for a taxable year for which a joint return was made shall be deemed to be that portion of the joint net operating loss (computed in accordance with paragraph (d) of § 1.172–3) which is attributable to the gross income and deductions of such spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing the joint net operating loss.

(2) *Taxable income to be subtracted—* (i) *Net operating loss of other spouse.* The taxable income of a particular spouse for any taxable year which is subtracted from the net operating loss of such spouse for another taxable year in order to determine the amount of such loss which may be carried back or carried over to still another taxable year is deemed to be, in a case in which such taxable income was reported in a joint return, the sum of the following:

(*a*) That portion of the combined taxable income of both spouses for such year for which the joint return was made which is attributable to the gross income and deductions of the particular spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing such combined taxable income, and

(*b*) That portion of such combined taxable income which is attributable to the other spouse; but, if such other spouse sustained a net operating loss in a taxable year beginning on the same date as the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted, then such portion shall first be reduced by such net operating loss of such other spouse.

(ii) *Modifications.* For purposes of this subparagraph, the combined taxable income shall be computed as though the combined income and deductions of both spouses were those of one individual. The provisions of § 1.172–5 shall apply in computing the combined taxable income for such purposes except that the net operating loss deduction shall be determined without taking into account any separate net operating loss of either spouse, or any joint net operating loss of both spouses, which was sustained in a taxable year beginning on or after the date of the beginning of the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted.

(e) *Recurrent use of joint return.* If a husband and wife making a joint return for any taxable year made a joint return for one or more, but not all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, such net operating loss carryover or net operating loss carryback to the taxable year is computed in the manner set forth in paragraph (d) of this section. Such net operating loss carryover or net operating loss carryback is considered a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(f) *Joint carryovers and carrybacks.* The joint net operating loss carryovers and the joint net operating loss carrybacks to any taxable year for which a joint return is made are all the net operating loss carryovers and net operating loss carrybacks of both spouses to such taxable year. For example, a husband and wife file a joint return for the calendar year 1956, having a joint taxable income for such year. The wife filed a separate return for the calendar years 1954 and 1955, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1955, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1955. The husband sustained net operating losses in both such taxable years. Since the husband and wife did not file a joint return for any taxable year involved in the computation of the net operating loss carryovers to 1956 from 1954 and 1955, the joint net operating loss carryovers to 1956 are the sepa-

rate net operating loss carryovers of the wife from the calendar years 1954 and 1955 and the separate net operating loss carryovers of the husband from the fiscal year ending June 30, 1955, and from the short taxable year ending December 31, 1955. If the husband and wife also file joint returns for the calendar years 1957, 1958, and 1959, having joint taxable income in 1957 and 1958 and a joint net operating loss in 1959, the joint net operating loss carrybacks to 1956, 1957, and 1958 from 1959 are computed on the basis of the joint net operating loss for 1959, since separate returns were not made for any taxable year involved in the computation of such carrybacks.

(g) *Illustration of principles.* In the following examples, which illustrate the application of this section, it is assumed that there are no items of adjustment under section 172(b)(2)(A) and that the taxable income or loss in each case is the taxable income or loss determined without any net operating loss deduction. The taxpayers in each example, H, a husband, and W, his wife, report their income on the calendar-year basis.

Example (1). H and W filed joint returns for 1954 and 1955. They sustained a joint net operating loss of $1,000 for 1954 and a joint net operating loss of $2,000 for 1955. For 1954 the deductions of H exceeded his gross income by $700, and the deductions of W exceeded her gross income by $300, the total of such amounts being $1,000. Therefore, $700 of the $1,000 joint net operating loss for 1954 is considered the net operating loss of H for 1954, and $300 of such joint net operating loss is considered the net operating loss of W for 1954. For 1955 the gross income of H exceeded his deductions, so that his separate taxable income would be $1,500, and the deductions of W exceeded her gross income by $3,500. Therefore, all of the $2,000 joint net operating loss for 1955 is considered the separate net operating loss of W for 1955.

Example (2). (i) H and W filed joint returns for 1954 and 1956, and separate returns for 1955 and 1957. For the years 1954, 1955, 1956, and 1957 they had taxable incomes and net operating losses as follows, losses being indicated in parentheses:

	1954	1955	1956	1957
H	($5,000)	($2,500)	$6,500	($4,000)
W	(3,000)	2,000	3,000	(1,500)
Total	(8,000)		9,500	

(ii) The net operating loss carryover of H from 1957 to 1958 is $4,000, that is, his $4,000 net operating loss for 1957 which is not reduced by any part of the taxable income for 1956, since none of such taxable income is attributable to H and the portion attributable to W is entirely offset by her separate net operating loss for her taxable year 1957, which taxable year begins on the same date as H's taxable year 1957. H's $4,000 net operating loss for 1957 likewise is not reduced by reference to 1955 since H sustained a loss in 1955. The $0 taxable income for 1956 which reduces H's net operating loss for 1957 is computed as follows:

(iii) The combined taxable income of $9,500 for 1956 is reduced to $1,000 by the net operating loss deduction for such year of $8,500. This net operating loss deduction is computed without taking into account any net operating loss of either H or W sustained in a taxable year beginning on or after January 1, 1957, the date of the beginning of the taxable year in which H sustained the net operating loss from which the taxable income is subtracted. This $8,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955, and of W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). None of the $1,000 combined taxable income for 1956 (computed with the net operating loss deduction described above) is attributable to H since it is caused by W's income (computed after deducting her separate carryover) offsetting H's loss (computed by deducting from his income his separate carryovers). No part of the $1,000 combined taxable income for 1956 which is attributable to W is used to reduce H's net operating loss for 1957 since such taxable income attributable to W must first be reduced by W's $1,500 net operating loss for 1957, her taxable year beginning on the same date as the taxable year of H in which he sustained the net operating loss from which the taxable income is subtracted.

(iv) The net operating loss carryover of W from 1957 to 1958 is $500, her $1,500 loss reduced by the sum of her $0 taxable income for 1955 (computed by taking into account her $3,000 carryover from 1954) and her $1,000 taxable income for 1956, that is, the portion of the combined taxable income for 1956 which is attributable to her.

Example (3). (i) Assume the same facts as in example (2) except that for 1957 the net operating loss of W is $200 instead of $1,500.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,200, that is, his $4,000 net operating loss for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $800 taxable income for 1956. Such $800 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added $800, the excess of the $1,000 taxable income for such year attributable to W over her $200 net operating loss sustained in 1957, a taxable year beginning on the same date as the taxable year of H in which he sustained the $4,000 net operating loss from which the taxable income is subtracted.

(iv) W has no net operating loss carryover from 1957 to 1958 since her net operating loss of $200 for 1957 does not exceed the $1,000 taxable income for 1956 attributable to her.

Example (4). (i) Assume the same facts as in example (2), except that W changes her accounting period in 1957 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1957, to January 31, 1957, or for the fiscal year February 1, 1957, to January 31, 1958, but has a net operating loss of $200 for the fiscal year February 1, 1958, to January 31, 1959.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,000, that is, his net operating loss of $4,000 for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $1,000 taxable income for 1956. Such $1,000 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added the $1,000 taxable income attributable to W for such year. The taxable income attributable to W is not reduced by any amount since she does not have a net operating loss for her taxable year beginning on January 1, 1957, the date of the beginning of the taxable year of H in which he sustained the $4,000 net operating loss from which his taxable income is subtracted.

(iv) The net operating loss carryover of W from the fiscal year beginning February 1, 1958, to her next fiscal year is $200, that is, her net operating loss of $200 for the fiscal year beginning February 1, 1958, reduced by the sum of her $0 taxable income for 1956, her $0 taxable income for the taxable year January 1, 1957, to January 31, 1957 (a year in which she had neither income nor loss), and her $0 taxable income for the fiscal year February 1, 1957, to January 31, 1958 (also a year in which she had neither income nor loss). The $0 taxable income for 1956 is computed as follows:

(v) The combined taxable income of $9,500 for 1956 is reduced to $0 amount by the net operating loss deduction for such year of $12,500. This net operating loss deduction is computed by taking into account the net operating loss of H for 1957 since it was sustained in a taxable year beginning before February 1, 1958, the date of the beginning of the taxable year of W in which she sustained the $200 net operating loss from which her taxable income is subtracted. This $12,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955 and of his carryback of $4,000 from 1957, plus W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). Since there is no combined taxable income for 1956, there is no taxable income attributable to W for such year.

§ 1.172–8 Net operating loss carryback for purposes of the excess profits tax.

(a) *Applicable rule.* In computing the excess profits tax imposed by subchapter D, chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if section 172 of the Internal Revenue Code of 1954 had not been enacted and as if section 122 of the Internal Revenue Code of 1939 were applicable to all pertinent taxable years to which the Internal Revenue Code of 1954 is otherwise applicable.

(b) *Illustrations.* The application of paragraph (a) of this section may be illustrated as follows:

(1) *Net operating loss.* The net operating loss itself, even though it is sustained in a taxable year which is otherwise subject to the Internal Revenue Code of 1954, shall be computed for this purpose under the provisions of section 122 of the Internal Revenue Code of 1939 and 26 C.F.R. (1939) 39.122–2 (Regulations 118) or the corresponding section of prior applicable regulations.

(2) *Net operating loss carryback.* (i) Since section 122 of the Internal Revenue Code of 1939 allows only a one-year carryback of a loss sustained in a taxable year beginning after December 31, 1949, only such one-year carryback shall be allowed for purposes of computing excess profits net income even though the loss is sustained in a taxable year ending after December 31, 1953, for which section 172(b)(1) otherwise allows a two-year carryback.

(ii) Thus, a calendar year taxpayer which sustains a net operating loss in 1954 may carry such loss back to both 1952 and 1953 for purposes of computing the normal tax and surtax imposed by sections 13 and 15, respectively, of the Internal Revenue Code of 1939, but may carry such loss back only to 1953 for purposes of computing excess profits net income in determining the excess profits tax imposed by subchapter D, chapter 1 of the Internal Revenue Code of 1939. Such 1954 loss shall have no effect on the determination of the excess profits

tax for 1952. The amount of the carryback from 1954 to 1953 for purposes of determining the excess profits tax for 1953 is an amount equal to the amount of the net operating loss computed as provided in subparagraph (1) of this paragraph.

(iii) A net operating loss sustained in the calendar year 1955 by such taxpayer may be carried back to 1953 for purposes of computing normal tax and surtax but shall have no effect on the determination of the excess profits tax for 1953 or for any other year.

§ 1.173 Statutory provisions; circulation expenditures.

SEC. 173. *Circulation expenditures.* Notwithstanding section 263, all expenditures (other than expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical) to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical shall be allowed as a deduction; except that the deduction shall not be allowed with respect to the portion of such expenditures as, under regulations prescribed by the Secretary or his delegate, is chargeable to capital account if the taxpayer elects, in accordance with such regulations, to treat such portion as so chargeable. Such election, if made, must be for the total amount of such portion of the expenditures which is so chargeable to capital account, and shall be binding for all subsequent taxable years unless, upon application by the taxpayer, the Secretary or his delegate permits a revocation of such election subject to such conditions as he deems necessary.

§ 1.173–1 Circulation expenditures.

(a) *Allowance of deduction.* Section 173 provides for the deduction from gross income of all expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical, subject to the following limitations:

(1) No deduction shall be allowed for expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical;

(2) The deduction shall be allowed only to the publisher making the circulation expenditures; and

(3) The deduction shall be allowed only for the taxable year in which such expenditures are paid or incurred. Subject to the provisions of paragraph (c) of this section, the deduction permitted under section 173 and this paragraph shall be allowed without regard to the method of accounting used by the taxpayer and notwithstanding the provisions of section 263 and the regulations thereunder, relating to capital expenditures.

(b) *Deferred expenditures.* Notwithstanding the provisions of paragraph (a) (3) of this section, expenditures paid or incurred in a taxable year subject to the Internal Revenue Code of 1939 which are deferrable pursuant to I.T. 3369 (C.B. 1940–1, 46), as modified by Rev. Rul. 57–87 (C.B. 1957–1, 507), may be deducted in the taxable year subject to the Internal Revenue Code of 1954 to which so deferred.

(c) *Election to capitalize.* (1) A taxpayer entitled to the deduction for circulation expenditures provided in section 173 and paragraph (a) of this section may, in lieu of taking such deduction, elect to capitalize the portion of such circulation expenditures which is properly chargeable to capital account. As a general rule, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account; conversely, expenditures made in an effort to establish or to increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions by telephone, the expenditures in connection therewith would not be properly chargeable to capital account. However, if such newspaper, in a special effort to increase its circulation, hires for a limited period 20 additional employees to obtain new subscriptions by means of telephone calls to the general public, the expenditures in connection therewith would be properly chargeable to capital account. If an election is made by a taxpayer to treat any portion of his circulation expenditures as chargeable to capital account, the election must apply to all such expenditures which are properly so chargeable. In such case, no deduction shall be allowed under section 173 for any such expenditures. In particular cases, the extent to which any deductions attributable to the amortization of capital expenditures are allowed may be determined under sections 162, 263, and 461.

(2) A taxpayer may make the election referred to in subparagraph (1) of this paragraph by attaching a statement to his return for the first taxable year to which the election is applicable. Once an election is made, the taxpayer must continue in subsequent taxable years to charge to capital account all circulation expenditures properly so chargeable, unless the Commissioner, on application made to him in writing by the taxpayer, permits a revocation of such election for any subsequent taxable year or years. Permission to revoke such election may be granted subject to such conditions as the Commissioner deems necessary.

(3) Elections filed under section 23 (bb) of the Internal Revenue Code of 1939 shall be given the same effect as if they were filed under section 173. (See section 7807 (b) (2).)

§ 1.174 Statutory provisions; research and experimental expenditures.

SEC. 174. *Research and experimental expenditures*—(a) *Treatment as expenses*—(1) *In general.* A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) *When method may be adopted*—(A) *Without consent.* A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this subsection for his first taxable year—

(i) Which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(ii) For which expenditures described in paragraph (1) are paid or incurred.

(B) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this subsection.

(3) *Scope.* The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

(b) *Amortization of certain research and experimental expenditures*—(1) *In general.* At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, research or experimental expenditures which are—

(A) Paid or incurred by the taxpayer in connection with his trade or business,

(B) Not treated as expenses under subsection (a), and

(C) Chargeable to capital account but not chargeable to property of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion),

may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016 (a) (1) (relating to adjustments to basis of property).

(2) *Time for and scope of election.* The election provided by paragraph (1) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

(c) *Land and other property.* This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.

(d) *Exploration expenditures.* This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e) *Cross reference.* For adjustments to basis of property for amounts allowed as deductions as deferred expenses under subsection (b), see section 1016 (a) (14).

§ 1.174–1 Research and experimental expenditures; in general.

Section 174 provides two methods for treating research or experimental ex-

penditures paid or incurred by the taxpayer in connection with his trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred (see § 1.174–3), or they may be deferred and amortized (see § 1.174–4). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. The expenditures to which section 174 applies may relate either to a general research program or to a particular project. See § 1.174–2 for the definition of research and experimental expenditures. The term "paid or incurred", as used in section 174 and in §§ 1.174–1 to 1.174–4, inclusive, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25).

§ 1.174–2 Definition of research and experimental expenditures.

(a) *In general.* (1) The term "research or experimental expenditures", as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. However, the term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. On the other hand, the term does not include the costs of acquiring another's patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

(2) The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on by the taxpayer's behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

(3) The application of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example (1). A engages B to undertake research and experimental work in order to create a particular product. B will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, A pays to B in respect of the project the sum of $150,000 of which $25,000 represents an addition to B's laboratory and the balance represents charges for research and experimentation on the project. It is agreed between the parties that A will absorb the entire cost of this addition to B's laboratory which will be retained by B. A may treat the entire $150,000 as expenditures under section 174.

Example (2). X Corporation, a manufacturer of explosives, contracts with the Y research organization to attempt through research and experimentation the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, Y is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project Y will transfer this tract, including any improvements thereon, to X. Section 174 does not apply to the amount paid to Y representing the costs of the tract of land and improvements.

(b) *Certain expenditures with respect to land and other property.* (1) Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 or depletion under section 611, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allowances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) Expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174 (a). Such expenditures cannot be amortized under section 174 (b) except to the extent provided in paragraph (a)(4) of § 1.174–4.

(3) If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174 (a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under section 174 (a). However, see subparagraph (4) of this paragraph.

(4) The deductions referred to in subparagraphs (2) and (3) of this paragraph for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. For the purpose of the preceding sentence, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. For example, a taxpayer undertakes to develop a new machine for use in his business. He expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174 (a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine).

(c) *Exploration expenditures.* The provisions of section 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas or other mineral. See sections 615 and 263.

§ 1.174–3 Treatment as expenses.

(a) *In general.* Research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174 (a). See paragraph (b) of this section. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner under section 174 (a) (3) with respect to part or all of the expenditures. See paragraph (b) (3) of this section. Thus, if a change to the deferred expense method under section 174 (b) is authorized by the Commissioner with respect to

research or experimental expenditures attributable to a particular project or projects, the taxpayer, for the taxable year of the change and for subsequent taxable years, must apply the deferred expense method to all such expenditures paid or incurred during any of those taxable years in connection with the particular project or projects, even though all other research and experimental expenditures are required to be deducted as current expenses under this section.. In no event will the taxpayer be permitted to adopt the method described in this section as to part of the expenditures relative to a particular project and adopt for the same taxable year a different method of treating the balance of the expenditures relating to the same project.

(b) *Adoption and change of method—*(1) *Adoption without consent.* The method described in this section may be adopted for any taxable year beginning after December 31, 1953, and ending after August 16, 1954. The consent of the Commissioner is not required if the taxpayer adopts the method for the first such taxable year in which he pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in his income tax return for such year a deduction for his research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which he incurs such expenditures, he cannot do so in subsequent taxable years unless he obtains the consent of the Commissioner under section 174 (a) (2) (B) and subparagraph (2) of this paragraph. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(2) *Adoption with consent.* A taxpayer may, with the consent of the Commissioner, adopt at any time the method provided in section 174 (a). The method adopted in this manner shall be applicable only to expenditures paid or incurred during the taxable year for which the request is made and in subsequent taxable years. A request to adopt this method shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D. C. The request shall set forth the name and address of the taxpayer, the first taxable year for which the adoption of the method is requested, and a description of the project or projects with respect to which research or experimental expenditures are to be, or have already been, paid or incurred. The request shall be signed by the taxpayer (or his duly authorized representative) and shall be filed not later than the last day of the first taxable year for which the adoption of the method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(3) *Change of method.* An application for permission to change to a different method of treating research or experimental expenditures shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D. C. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the last day of the first taxable year for which the change in method is to apply. See, however, subparagraph (4) of this paragraph, relating to extensions of time. The application shall—

(i) State the first year to which the requested change is to be applicable;

(ii) State whether the change is to apply to all research or experimental expenditures paid or incurred by the taxpayer, or only to expenditures attributable to a particular project or projects;

(iii) Include such information as will identify the project or projects to which the change is applicable;

(iv) Indicate the number of months (not less than 60) selected for amortization of the expenditures, if any, which are to be treated as deferred expenses under section 174 (b);

(v) State that, upon approval of the application, the taxpayer will make an accounting segregation on his books and records of the research or experimental expenditures to which the change in method is to apply; and

(vi) State the reasons for the change.

If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting permission to his income tax return for the first taxable year in which the different method is effective.

(4) *Special rules.* If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 174 (a) is applicable falls before January 2, 1958, consent is hereby given for the taxpayer to adopt the expense method or to change from the expense method to a different method. In the case of a change from the expense method to a different method, the taxpayer, on or before January 2, 1958, must submit to the district director for the internal revenue district in which the return was filed the information required by subparagraph (3) of this paragraph. For any taxable year for which the expense method or a different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958, if such return is necessary.

§ 1.174–4 Treatment as deferred expenses.

(a) *In general.* (1) If a taxpayer has not adopted the method provided in section 174(a) of treating research or experimental expenditures paid or incurred by him in connection with his trade or business as currently deductible expenses, he may, for any taxable year beginning after December 31, 1953, elect to treat such expenditures as deferred expenses under section 174 (b), subject to the limitations of subparagraph (2) of this paragraph. If a taxpayer has adopted the method of treating such expenditures as expenses under section 174 (a), he may not elect to defer and amortize any such expenditures unless permission to do so is granted under section 174 (a) (3). See paragraph (b) of this section.

(2) The election to treat research or experimental expenditures as deferred expenses under section 174 (b) applies only to those expenditures which are chargeable to capital account but which are not chargeable to property of a character subject to an allowance for depreciation or depletion under section 167 or 611, respectively. Thus, the election under section 174 (b) applies only if the property resulting from the research or experimental expenditures has no determinable useful life. If the property resulting from the expenditures has a determinable useful life, section 174 (b) is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life. Amounts treated as deferred expenses are properly chargeable to capital account for purposes of section 1016 (a) (1), relating to adjustments to basis of property. See section 1016 (a) (14). See section 174(c) and paragraph (b) (1) of § 1.174–2 for treatment of expenditures for the acquisition or improvement of land or of depreciable or depletable property to be used in connection with the research or experimentation.

(3) Expenditures which are treated as deferred expenses under section 174 (b) are allowable as a deduction ratably over a period of not less than 60 consecutive months beginning with the month in which the taxpayer first realizes benefits from the expenditures. The length of the period shall be selected by the taxpayer at the time he makes the election to defer the expenditures. If a taxpayer has two or more separate projects, he may select a different amortization period for each project. In the absence of a showing to the contrary, the taxpayer will be deemed to have begun to realize benefits from the deferred expenditures in the month in which the taxpayer first puts the process, formula, invention, or similar property to which the expenditures relate to an income-producing use. See section 1016 (a) (14) for adjustments to basis of property for amounts allowed as deductions under section 174 (b) and this section. See section 165 and the regulations thereunder for rules relating to the treatment of losses resulting from abandonment.

(4) If expenditures which the taxpayer has elected to defer and deduct ratably over a period of time in accordance with section 174 (b) result in the development of depreciable property, deductions for the unrecovered expenditures, beginning with the time the asset becomes depreciable in character, shall be determined under section 167 (relating to depreciation) and the regulations thereunder. For example, for the taxable year 1954, A, who reports his income on the basis of a calendar year, elects to defer and deduct ratably over a period of 60 months research and experimental expenditures made in connection with a particular project. In 1956, the total of the deferred expenditures amounts to $60,000. At that time, A has developed a process which he seeks to patent. On July 1, 1956, A first realized benefits from the marketing of products resulting from this process. Therefore, the expenditures deferred are deductible ratably over the 60-month period beginning with July 1, 1956 (when A first realized benefits from the project). In his return for

the year 1956, A deducted $6,000; in 1957, A deducted $12,000 ($1,000 per month). On July 1, 1958, a patent protecting his process is obtained by A. In his return for 1958, A is entitled to a deduction of $6,000, representing the amortizable portion of the deferred expenses attributable to the period prior to July 1, 1958. The balance of the unrecovered expenditures ($60,000 minus $24,000, or $36,000) is to be recovered as a depreciation deduction over the life of the patent commencing with July 1, 1958. Thus, one-half of the annual depreciation deduction based upon the useful life of the patent is also deductible for 1958 (from July 1 to December 31).

(5) The election shall be applicable to all research and experimental expenditures paid or incurred by the taxpayer or, if so limited by the taxpayer's election, to all such expenditures with respect to the particular project, subject to the limitations of subparagraph (2) of this paragraph. The election shall apply for the taxable year for which the election is made and for all subsequent taxable years, unless a change to a different treatment is authorized by the Commissioner under section 174 (b) (2). See paragraph (b) (2) of this section. Likewise, the taxpayer shall adhere to the amortization period selected at the time of the election unless a different period of amortization with respect to a part or all of the expenditures is similarly authorized. However, no change in method will be permitted with respect to expenditures paid or incurred before the taxable year to which the change is to apply. In no event will the taxpayer be permitted to treat part of the expenditures with respect to a particular project as deferred expenses under section 174 (b) and to adopt a different method of treating the balance of the expenditures relating to the same project for the same taxable year. The election under this section shall not apply to any expenditures paid or incurred before the taxable year for which the taxpayer makes the election.

(b) *Election and change of method*—(1) *Election.* The election under section 174 (b) shall be made not later than the time (including extensions) prescribed by law for filing the return for the taxable year for which the method is to be adopted. The election shall be made by attaching a statement to the taxpayer's return for the first taxable year to which the election is applicable. The statement shall be signed by the taxpayer (or his duly authorized representative), and shall—

(i) Set forth the name and address of the taxpayer;

(ii) Designate the first taxable year to which the election is to apply;

(iii) State whether the election is intended to apply to all expenditures within the permissible scope of the election, or only to a particular project or projects, and, if the latter, include such information as will identify the project or projects as to which the election is to apply;

(iv) Set forth the amount of all research or experimental expenditures paid or incurred during the taxable year for which the election is made;

(v) Indicate the number of months (not less than 60) selected for amortization of the deferred expenses for each project; and

(vi) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(2) *Change to a different method or period.* Application for permission to change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D. C. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the end of the first taxable year in which the different method or different amortization period is to be used (unless subparagraph (3) of this paragraph, relating to extensions of time, is applicable). The application shall set forth the following information with regard to the research or experimental expenditures which are being treated under section 174 (b) as deferred expenses:

(i) Total amount of research or experimental expenditures attributable to each project;

(ii) Amortization period applicable to each project; and

(iii) Unamortized expenditures attributable to each project at the beginning of the taxable year in which the application is filed.

In addition, the application shall set forth the length of the new period or periods proposed, or the new method of treatment proposed, the reasons for the proposed change, and such information as will identify the project or projects to which the expenditures affected by the change relate. If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting the permission to his income tax return for the first taxable year in which the different method or period is to be effective.

(3) *Special rules.* If the last day prescribed by law for filing a return for any taxable year for which the deferred method provided in section 174 (b) has been adopted falls before January 2, 1958, consent is hereby given for the taxpayer to change from such method and adopt a different method of treating research or experimental expenditures, provided that on or before January 2, 1958, he submits to the district director for the district in which the return was filed the information required by subparagraph (2) of this paragraph, relating to a change to a different method or period. For any taxable year for which the different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958.

(c) *Example.* The application of this section is illustrated by the following example:

Example. N Corporation is engaged in the business of manufacturing chemical products. On January 1, 1955, work is begun on a special research project. N Corporation elects, pursuant to section 174 (b), to defer the expenditures relating to the special project and to amortize the expenditures over a period of 72 months beginning with the month in which benefits from the expenditures are first realized. On January 1, 1955, N Corporation also purchased for $57,600 a building having a remaining useful life of 12 years as of the date of purchase and no salvage value at the end of the period. Fifty percent of the building's facilities are to be used in connection with the special research project. During 1955, N Corporation pays or incurs the following expenditures relating to the special research project:

Salaries	$15,000
Heat, light and power	700
Drawings	$2,000
Models	6,500
Laboratory materials	8,000
Attorneys' fees	1,400
Depreciation on building attributable to project (50 percent of $4,800 allowable depreciation)	2,400
Total research and development expenditures	36,000

The above expenditures result in a process which is marketable but not patentable and which has no determinable useful life. N Corporation first realizes benefits from the process in January 1956. N Corporation is entitled to deduct the amount of $6,000 $\left(\frac{\$36,000 \times 12 \text{ months}}{72 \text{ months}}\right)$ as deferred expenses under section 174 (b) in computing taxable income for 1956.

§ 1.175 Statutory provisions; soil and water conservation expenditures.

SEC. 175. *Soil and water conservation expenditures*—(a) *In general.* A taxpayer engaged in the business of farming may treat expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(b) *Limitation.* The amount deductible under subsection (a) for any taxable year shall not exceed 25 percent of the gross income derived from farming during the taxable year. If for any taxable year the total of the expenditures treated as expenses which are not chargeable to capital account exceeds 25 percent of the gross income derived from farming during the taxable year, such excess shall be deductible for succeeding taxable years in order of time; but the amount deductible under this section for any one such succeeding taxable year (including the expenditures actually paid or incurred during the taxable year) shall not exceed 25 percent of the gross income derived from farming during the taxable year.

(c) *Definitions.* For purposes of subsection (a)—

(1) The term "expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming" means expenditures paid or incurred for the treatment or moving of earth, including (but not limited to) leveling, grading and terracing, contour furrowing, the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and the planting of

windbreaks. Such term does not include—

(A) The purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167, or

(B) Any amount paid or incurred which is allowable as a deduction without regard to this section.

Notwithstanding the preceding sentences, such term also includes any amount, not otherwise allowable as a deduction, paid or incurred to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by such district which, if paid or incurred by the taxpayer, would without regard to this sentence constitute expenditures deductible under this section.

(2) The term "land used in farming" means land used (before or simultaneously with the expenditures described in paragraph (1)) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

(d) *When method may be adopted—Without consent.* A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this section for his first taxable year—

(A) Which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(B) For which expenditures described in subsection (a) are paid or incurred.

(2) *With consent.* A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this section.

(e) *Scope.* The method adopted under this section shall apply to all expenditures described in subsection (a). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

§ 1.175–1 Soil and water conservation expenditures; in general.

Under section 175, a farmer may deduct his soil or water conservation expenditures which do not give rise to a deduction for depreciation and which are not otherwise deductible. The amount of the deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over and deducted in succeeding taxable years. As a general rule, once a farmer has adopted this method of treating soil and water conservation expenditures, he must deduct all such expenditures (subject to the 25-percent limitation) for the current and subsequent taxable years. If a farmer does not adopt this method, such expenditures increase the basis of the property to which they relate.

§ 1.175–2 Definition of soil and water conservation expenditures.

(a) *Expenditures treated as a deduction.* (1) The method described in section 175 applies to expenditures paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, but only if such expenditures are made in the furtherance of the business of farming. More specifically, a farmer may deduct expenditures made for these purposes which are for (i) the treatment or moving of earth, (ii) the construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds, (iii) the eradication of brush, and (iv) the planting of windbreaks. Expenditures for the treatment or moving of earth include but are not limited to expenditures for leveling, conditioning, grading, terracing, contour furrowing, and restoration of soil fertility.

(2) The following are examples of soil and water conservation: (i) Constructing terraces, or the like, to detain or control the flow of water, to check soil erosion on sloping land, to intercept run-off, and to divert excess water to protected outlets; (ii) constructing water detention or sediment retention dams to prevent or fill gullies, to retard or reduce run-off of water, or to collect stock water; and (iii) constructing earthen floodways, levies, or dikes, to prevent flood damage to farmland.

(b) *Expenditures not subject to section 175 treatment.* (1) The method described in section 175 applies only to expenditures for nondepreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities subject to the allowance for depreciation. Thus, the method does not apply to depreciable nonearthen items such as those made of masonry or concrete (see section 167). For example, expenditures in respect of depreciable property include those for materials, supplies, wages, fuel, hauling, and dirt moving for making structures such as tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. Similarly, the method is not applicable to expenditures for fertilizer effective substantially longer than one year, since such expenditures are also depreciable. However, the method applies to expenditures for earthen items which are not subject to a depreciation allowance. For example, expenditures for earthen terraces and dams which are nondepreciable are deductible under section 175.

(2) The method does not apply to expenses deductible apart from section 175. Adoption of the method is not necessary in order to deduct such expenses in full without limitation. Thus, the method does not apply to interest (deductible under section 163), nor to taxes (deductible under section 164). It does not apply to expenses for the repair of completed soil or water conservation structures, such as costs of annual removal of sediment from a drainage ditch. It does not apply to expenditures paid or incurred primarily to produce an agricultural crop even though they incidentally conserve soil. Thus, the cost of fertilizer (the effectiveness of which does not last beyond one year) used to produce hay is deductible without adoption of the method described in section 175. However, the method would apply to expenses incurred to produce vegetation primarily to conserve soil or water or to prevent erosion. Thus, for example, the method would apply to such expenditures as the cost of dirt moving, lime, fertilizer, seed and planting stock used in gully stabilization, or in stabilizing severely eroded areas, in order to obtain a soil binding stand of vegetation on raw or infertile land.

(c) *Assessments.* The method applies also to that part of assessments levied by a soil or water conservation or drainage district to reimburse it for its expenditures which, if actually paid or incurred during the taxable year by the taxpayer directly, would be deductible under section 175. Depending upon the farmer's method of accounting, the time when the farmer pays or incurs the assessment, and not the time when the expenditures are paid or incurred by the district, controls the time the deduction must be taken. The provisions of this paragraph may be illustrated by the following example:

Example. In 1955 a soil and water conservation district levies an assessment of $700 upon a farmer on the cash method of accounting. The assessment is to reimburse the district for its expenditures in 1954. The farmer's share of such expenditures is as follows: $400 for digging drainage ditches for soil conservation and $300 for assets subject to the allowance for depreciation. If the farmer pays the assessment in 1955 and has adopted the method of treating expenditures for soil or water conservation as current expenses under section 175, he may deduct in 1955 the $400 attributable to the digging of drainage ditches as a soil conservation expenditure subject to the 25-percent limitation.

§ 1.175–3 Definition of "the business of farming."

The method described in section 175 is available only to a taxpayer engaged in "the business of farming". A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the business of farming. For the purpose of this section, the term "farm" is used in its ordinary, accepted sense and includes stock, dairy, poultry, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A taxpayer is engaged in "the business of farming" if he is a member of a partnership engaged in the business of farming. See paragraphs (a) (8) (i) and (c) (1) (iv) of § 1.702–1.

§ 1.175–4 Definition of "land used in farming."

(a) For the purpose of section 175, the term "land used in farming" means land which is used in the business of farming and which meets both of the following requirements:

(1) The land must be used for the production of crops, fruits, or other agri-

ductible in that year, into the next year,

cultural products or for the sustenance of livestock. The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. It does not include fish, frogs, reptiles, and the like. Land used for the sustenance of livestock includes land used for grazing such livestock.

(2) The land must be or have been so used either by the taxpayer or his tenant at some time before, or at the same time as, the taxpayer makes the expenditures for soil or water conservation or for the prevention of the erosion of land. The taxpayer will be considered to have used the land in farming before making such expenditures if he or his tenant has employed the land in a farming use in the past. If the expenditures are made by the taxpayer in respect of land newly acquired from one who immediately prior to the acquisition was using it in farming, the taxpayer will be considered to be using the land in farming at the time that such expenditures are made, if the use which is made by the taxpayer of the land from the time of its acquisition by him is substantially a continuation of the use which was made of the land immediately prior to its acquisition. On the other hand, if the land is being initially prepared by the taxpayer in order to make it suitable for a particular farming use other than the one to which the land was devoted prior to its acquisition by the taxpayer, such land is not considered to be "land used in farming" at the time of its preparation.

(b) The provisions of paragraph (a) of this section may be illustrated by the following examples:

Example (1). A purchases an operating farm from B in the autumn after B has harvested his crops. At the time of such purchase the land is suitable for A's particular farming use without the necessity of making initial preparatory expenditures. Prior to spring plowing and planting when the land is idle because of the season, A makes certain soil and water conservation expenditures on this farm. At the time such expenditures are made the land is considered to be used by A in farming, and A may deduct such expenditures under section 175, subject to the other requisite conditions of such section.

Example (2). C acquires uncultivated land which he intends to develop for farming. Prior to putting this land into production it is necessary for C to clear brush, construct earthen terraces and ponds, and make other soil and water conservation expenditures. The land is not used in farming at the same time that such expenditures are made. Therefore, C may not deduct such expenditures under section 175.

Example (3). D acquires several tracts of land from persons who had used such land for grazing cattle. D intends to use the land for a citrus grove. In order to make the land suitable for this use, D constructs earthen terraces, builds drainage ditches and irrigation ditches, extensively treats the soil, and makes other soil and water conservation expenditures. The land is not used in farming by D at the time he makes such expenditures, but is being initially prepared for use as a citrus grove. Therefore, D may not deduct such expenditures under section 175.

§ 1.175–5 Percentage limitation and carryover.

(a) *The limitation*—(1) *General rule.* The amount of soil and water conservation expenditures which the taxpayer may deduct under section 175 in any one taxable year is limited to 25 percent of his "gross income from farming".

(2) *Definition of "gross income from farming".* For the purpose of section 175, the term "gross income from farming" means the gross income of the taxpayer, derived in "the business of farming" as defined in § 1.175–3, from the production of crops, fruits, or other agricultural products or from livestock (including livestock held for draft, breeding, or dairy purposes). It includes such income from land used in farming other than that upon which expenditures are made for soil or water conservation or for the prevention of erosion of land. It does not include gains from sales of assets such as farm machinery or gains from the disposition of land. A taxpayer shall compute his "gross income from farming" in accordance with his accounting method used in determining gross income. (See the regulations under section 61 relating to accounting methods used by farmers in determining gross income.) The provisions of this subparagraph may be illustrated by the following example:

Example. A, who uses the cash receipts and disbursements method of accounting, includes in his "gross income from farming" for purposes of determining the 25-percent limitation the following items:

Proceeds from sale of his 1955 yield of corn	$10,000
Gain from disposition of old breeding cows replaced by younger cows	500
Total gross income from farming	10,500

A must exclude from "gross income from farming" the following items which are included in his gross income:

Gain from sale of tractor	$100
Gain from sale of 40 acres of taxpayer's farm	8,000
Interest on loan to neighboring farmer	100

(3) *Deduction qualifies for net operating loss deduction.* Any amount allowed as a deduction under section 175, either for the year in which the expenditure is paid or incurred or for the year to which it is carried, is taken into account in computing a net operating loss for such taxable year. If a deduction for soil or water conservation expenditures has been taken into account in computing a net operating loss carryback or carryover, it shall not be considered a soil or water conservation expenditure for the year to which the loss is carried, and therefore, is not subject to the 25-percent limitation for that year. The provisions of this subparagraph may be illustrated by the following example:

Example. Assume that in 1956 A has gross income from farming of $4,000, soil and water conservation expenditures of $1,600, and deductible farm expenses of $3,500. Of the soil and water conservation expenditures, $1,000 is deductible in 1956. The $600 in excess of 25 percent of A's gross income from farming is carried over into 1957. Assuming that A has no other income, his deductions of $4,500 ($1,000 plus $3,500) exceed his gross income of $4,000 by $500. This $500 will constitute a net operating loss which he must carry back two years and carry forward five years, until it has offset $500 of taxable income. No part of this $500 net operating loss carryback or carryover will be taken into account in determining the amount of soil and water conservation expenditures in the years to which it is carried.

(b) *Carryover of expenditures in excess of deduction.* The deduction for soil and water conservation expenditures in any one taxable year is limited to 25 percent of the taxpayer's gross income from farming. The taxpayer may carry over the excess of such expenditures over 25 percent of his gross income from farming into his next taxable year, and, if not deductible in that year, into the next year, and so on without limit as to time. In determining the deductible amount of such expenditures for any taxable year, the actual expenditures of that year shall be added to any such expenditures carried over from prior years, before applying the 25-percent limitation. Any such expenditures in excess of the deductible amount may be carried over during the taxpayer's entire existence. For this purpose in a farm partnership, since the 25-percent limitation is applied to each partner, not the partnership, the carryover may be carried forward during the life of the partner. The provisions of this paragraph may be illustrated by the following example:

Example. Assume the expenditures and income shown in the following table:

Year	Deductible soil and water conservation expenditures: Paid or incurred during taxable year	Deductible soil and water conservation expenditures: Carried forward from prior year	Total	25 percent of gross income from farming	Excess to be carried forward
1954	$900	None	$900	$800	$100
1955	1,000	$100	1,100	900	200
1956	None	200	200	1,000	None

The deduction for 1954 is limited to $800. The remainder, $100 ($900 minus $800), not being deductible for 1954, is a carryover to 1955. For 1955, accordingly, the total of the expenditures to be taken into account is $1,100 (the $100 carryover and the $1,000 actually paid in that year). The deduction for 1955 is limited to $900, and the remainder of the $1,100 total, or $200, is a carryover to 1956. The deduction for 1956 consists solely of this carryover of $200. Since the total expenditures, actual and carried-over, for 1956 are less than 25 percent of gross income from farming, there is no carryover into 1957.

§ 1.175–6 Adoption or change of method.

(a) *Adoption without consent.* A taxpayer may, without consent, adopt the method of treating expenditures for soil or water conservation as expenses for the first taxable year:

(1) Which begins after December 31, 1953, and ends after August 16, 1954, and

(2) For which soil or water conservation expenditures described in section 175 (a) are paid or incurred.

Such adoption shall be made by claiming the deduction on his income tax return. For a taxable year ending prior to May 31, 1957, the adoption of the method described in section 175 shall be made by claiming the deduction on such return for that year, or by claiming the deduction on an amended return filed for that year on or before August 30, 1957.

(b) *Adoption with consent.* A taxpayer may adopt the method of treating soil and water conservation expenditures as provided by section 175 for any taxable year to which the section is applicable if consent is obtained from the district director for the internal revenue district in which the taxpayer's return is required to be filed.

(c) *Change of method.* A taxpayer who has adopted the method of treating expenditures for soil or water conservation, as provided by section 175, may change from this method and capitalize such expenditures made after the effective date of the change, if he obtains the consent of the district director for the internal revenue district in which his return is required to be filed.

(d) *Request for consent to adopt or change method.* Where the consent of the district director is required under paragraph (b) or (c) of this section, the request for his consent shall be in writing, signed by the taxpayer or his authorized representative, and shall be filed not later than the date prescribed by law for filing the income tax return for the first taxable year to which the adoption of, or change of, method is to apply, or not later than August 20, 1957, following their adoption, whichever is later. The request shall:

(1) Set forth the name and address of the taxpayer;

(2) Designate the first taxable year to which the method or change of method is to apply;

(3) State whether the method or change of method is intended to apply to all expenditures within the permissible scope of section 175, or only to a particular project or farm and, if the latter, include such information as will identify the project or farm as to which the method or change of method is to apply;

(4) Set forth the amount of all soil and water conservation expenditures paid or incurred during the first taxable year for which the method or change of method is to apply; and

(5) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(e) *Scope of method.* Except with the consent of the district director as provided in paragraph (b) or (c) of this section, the taxpayer's method of treating soil and water conservation expenditures described in section 175 shall apply to all such expenditures for the taxable year of adoption and all subsequent taxable years. Although a taxpayer may have elected to deduct soil and water conservation expenditures, he may request an authorization to capitalize his soil and water conservation expenditures attributable to a special project or single farm. Similarly, a taxpayer who has not elected to deduct such expenditures may request an authorization to deduct his soil and water conservation expenditures attributable to a special project or single farm. The authorization with respect to the special project or single farm will not affect the method adopted with respect to the taxpayer's regularly incurred soil and water conservation expenditures. No adoption of, or change of, the method under section 175 will be permitted as to expenditures actually paid or incurred before the taxable year to which the method or change of method is to apply. Thus, if a taxpayer adopts such method for 1956, he cannot deduct any part of such expenditures which he capitalized, or should have capitalized, in 1955. Likewise, if a taxpayer who has adopted such method has an unused carryover of such expenditures in excess of the 25-percent limitation, and is granted consent to capitalize soil and water conservation expenditures beginning in 1956, he cannot capitalize any part of the unused carryover. The excess expenditures carried over continue to be deductible to the extent of 25 percent of the taxpayer's gross income from farming. No adjustment to the basis of land shall be made under section 1016 for expenditures to which the method under section 175 applies. For example, A has an unused carryover of soil and water conservation expenditures amounting to $5,000 as of December 31, 1956. On January 1, 1957, A sells his farm and goes out of the business of farming. The unused carryover of $5,000 cannot be added to the basis of the farm for purposes of determining gain or loss on its sale. In 1959, A purchases another farm and resumes the business of farming. In such year, A may deduct the amount of the unused carryover to the extent of 25 percent of his gross income from farming and may carry over any excess to subsequent years.

§ 1.176 Statutory provisions; payments with respect to employees of certain foreign corporations.

SEC. 176. *Payments with respect to employees of certain foreign corporations.* In the case of a domestic corporation, there shall be allowed as a deduction amounts (to the extent not compensated for) paid or incurred pursuant to an agreement entered into under section 3121 (l) with respect to services performed by United States citizens employed by foreign subsidiary corporations. Any reimbursement of any amount previously allowed as a deduction under this section shall be included in gross income for the taxable year in which received.

[Sec. 176 as added by sec. 210, Social Security Amendments 1954 (68 Stat. 1052)]

§ 1.177 Statutory provisions; trademark and trade name expenditures.

SEC. 177. *Trademark and trade name expenditures*—(a) *Election to amortize.* Any trademark or trade name expenditure paid or incurred during a taxable year beginning after December 31, 1955, may, at the election of the taxpayer (made in accordance with regulations prescribed by the Secretary or his delegate), be treated as a deferred expense. In computing taxable income, all expenditures paid or incurred during the taxable year which are so treated shall be allowed as a deduction ratably over such period of not less than 60 months (beginning with the first month in such taxable year) as may be selected by the taxpayer in making such election. The expenditures so treated are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustments to basis of property).

(b) *Trademark and trade name expenditures defined.* For purposes of subsection (a), the term "trademark or trade name expenditure" means any expenditure which—

(1) Is directly connected with the acquisition, protection, expansion, registration (Federal, State, or foreign), or defense of a trademark or trade name;

(2) Is chargeable to capital account; and

(3) Is not part of the consideration paid for a trademark, trade name, or business.

(c) *Time for and scope of election.* The election provided by subsection (a) shall be made within the time prescribed by law (including extensions thereof) for filing the return for the taxable year during which the expenditure is paid or incurred. The period selected by the taxpayer under subsection (a) with respect to the expenditures paid or incurred during the taxable year which are treated as deferred expenses shall be adhered to in computing his taxable income for the taxable year for which the election is made and all subsequent years.

(d) *Cross reference.* For adjustments to basis of property for amounts allowed as deductions for expenditures treated as deferred expenses under this section, see section 1016(a)(16).

[Sec. 177 as added by sec. 4(a), Act of June 29, 1956 (Pub. Law 629, 84th Cong., 70 Stat. 406)]

§ 1.177–1 Election to amortize trademark and trade name expenditures.

(a) *In general.* (1) Section 177 provides that a taxpayer may elect to treat any trademark or trade name expenditure (defined in section 177(b) and paragraph (b) of this section) paid or incurred during a taxable year beginning after December 31, 1955, as a deferred expense. Any expenditure so treated shall be allowed as a deduction ratably over the number of continuous months (not less than 60) selected by the taxpayer, beginning with the first month of the taxable year in which the expenditure is paid or incurred. The term "paid or incurred", as used in section 177 and this section, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25). An election under section 177 is irrevocable insofar as it applies to a particular trademark or trade name expenditure, but separate elections may be made with respect to other trademark or trade name expenditures. See subparagraph (3) of this paragraph. See also paragraph (c) of this section for time and manner of making election.

(2) The number of continuous months selected by the taxpayer may be equal to or greater, but not less, than 60, but in any event the deduction must begin with the first month of the taxable year in which the expenditure is paid or incurred. The number of months selected by the taxpayer at the time he makes the election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(3) Section 177 permits an election by the taxpayer for each separate trademark or trade name expenditure. Thus,

a taxpayer who has several trademark or trade name expenditures in a taxable year may elect under section 177 with respect to some of such expenditures and not elect with respect to the other expenditures. Also, a taxpayer may choose different amortization periods for different trademark or trade name expenditures with respect to which he has made the election under section 177.

(4) All trademark and trade name expenditures are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property, whether or not they are to be amortized under section 177. However, the trademark and trade name expenditures with respect to which the taxpayer has made an election under section 177 must be kept in a separate account in the taxpayer's books and records. See paragraph (c) of this section. See also section 1016(a)(16) and paragraph (m) of § 1.1016–5 for adjustments to basis of property for amounts allowed as deductions under section 177 and this section.

(b) *Trademark and trade name expenditures defined.* (1) The term "trademark and trade name expenditure", as used in section 177 and this section, means any expenditure which—

(i) Is directly connected with the acquisition, protection, expansion, registration (Federal, State, or foreign), or defense of a trademark or trade name;

(ii) Is chargeable to capital account; and

(iii) Is not part of the consideration or purchase price paid for a trademark, trade name, or a business (including goodwill) already in existence.

An expenditure which fails to meet one or more of these tests is not a trademark or trade name expenditure for purposes of section 177 and this section. Amounts paid in connection with the acquisition of an existing trademark or trade name may not be amortized under section 177 even though such amounts may be paid to protect or expand a previously owned trademark or trade name through purchase of a competitive trademark. Similarly, the provisions of section 177 and this section are not applicable to expenditures paid or incurred for an agreement to discontinue the use of a trademark or trade name (if the effect of the agreement is the purchase of a trademark or trade name) nor to expenditures paid or incurred in acquiring franchises or rights to the use of a trademark or trade name. Generally, section 177 will apply to expenditures such as legal fees and other costs in connection with the acquisition of a certificate of registration of a trademark from the United States or other government, artists' fees and similar expenses connected with the design of a distinctive mark for a product or service, litigation expenses connected with infringement proceedings, and costs in connection with the preparation and filing of an application for renewal of registration and continued use of a trademark.

(2) Expenditures for a trademark or trade name which has a determinable useful life and which would otherwise be depreciable under section 167 must be deferred and amortized under section 177 if an election under section 177 is made with respect to such expenditures.

(3) The following examples illustrate the application of section 177:

Example (1). X Corporation engages an artist to design a distinctive trademark for its product. At the same time it retains an attorney to prepare the papers necessary for registration of this trademark with the Federal Government. The fees of both the artist and the attorney may be amortized under section 177 over a period of not less than 60 continuous months.

Example (2). Y Corporation wishes to expand the market served by its product. It acquires a competing firm in a neighboring State. The contract of sale provides for a purchase price of $250,000 of which $225,000 shall constitute payment for physical assets and $25,000 for the trademark and goodwill. No part of the purchase price may be amortized under section 177.

Example (3). M Corporation brings suit against N Corporation for infringement of M's trademark. The costs of this litigation may be amortized under section 177.

(c) *Time and manner of making election.* (1) A taxpayer who elects to defer and amortize any trademark or trade name expenditure paid or incurred during a taxable year beginning after December 31, 1955, shall, within the time prescribed by law (including extensions thereof) for filing his income tax return for that year, attach to his income tax return a statement signifying his election under section 177 and setting forth the following:

(i) Name and address of the taxpayer, and the taxable year involved;

(ii) An identification of the character and amount of each expenditure to which the election applies and the number of continuous months (not less than 60) during which the expenditures are to be ratably deducted; and

(iii) A declaration by the taxpayer that he will make an accounting segregation on his books and records of the trademark and trade name expenditures for which the election has been made, sufficient to permit an identification of the character and amount of each such expenditure and the amortization period selected for each expenditure.

(2) The provisions of subparagraph (1) of this paragraph shall apply to income tax returns and statements required to be filed after May 4, 1960. Elections properly made in accordance with the provisions of Treasury Decision 6209, approved October 26, 1956 (21 F.R. 8319, C.B. 1956–2, 1370), continue in effect.

ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

§ 1.211 Statutory provisions; allowance of deductions.

SEC. 211. *Allowance of deductions.* In computing taxable income under section 63 (a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (section 261 and following, relating to items not deductible).

§ 1.211–1 Allowance of deductions.

In computing taxable income under section 63(a), the deductions provided by sections 212, 213, 214, 215, and 216 shall be allowed subject to the exceptions provided in part IX subchapter B, chapter 1 of the Code (section 261 and following, relating to items not deductible).

§ 1.212 Statutory provisions; expenses for production of income.

SEC. 212. *Expenses for production of income.* In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) For the production or collection of income;

(2) For the management, conservation, or maintenance of property held for the production of income; or

(3) In connection with the determination, collection, or refund of any tax.

§ 1.212–1 Nontrade or nonbusiness expenses.

(a) An expense may be deducted under section 212 only if—

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

(c) Expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management,

conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

(d) Expenses, to be deductible under section 212, must be "ordinary and necessary". Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(e) A deduction under section 212 is subject to the restrictions and limitations in part IX (section 261 and following), subchapter B, chapter 1 of the Code, relating to items not deductible. Thus, no deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income. See section 265. Nor does section 212 allow the deduction of any expenses which are disallowed by any of the provisions of subtitle A of the Code, even though such expenses may be paid or incurred for one of the purposes specified in section 212.

(f) Among expenditures not allowable as deductions under section 212 are the following: Commuter's expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses paid or incurred in securing admission to the bar, and corresponding fees and expenses paid or incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions. See, however, section 162 and the regulations thereunder.

(g) Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

(h) Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642 (g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

(j) Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

(l) Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determing the extent of his tax liability or in contesting his tax liability are deductible.

(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

(o) The provisions of section 212 are not intended in any way to disallow expenses which would otherwise be allowable under section 162 and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.

§ 1.213 Statutory provisions; medical, dental, etc., expenses.

SEC. 213. *Medical, dental, etc., expenses*—(a) *Allowance of deduction.* There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152)—

(1) If neither the taxpayer nor his spouse has attained the age of 65 before the close of the taxable year, to the extent that such expenses exceed 3 percent of the adjusted gross income; or

(2) If either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year—

(A) The amount of such expenses for the care of the taxpayer and his spouse, and

(B) The amount by which such expenses for the care of such dependents exceed 3 percent of the adjusted gross income.

(b) *Limitation with respect to medicine and drugs.* Amounts paid during the taxable year for medicine and drugs which (but for this subsection) would be taken into account in computing the deduction under subsection (a) shall be taken into account only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income.

(c) *Maximum limitations.* Except as provided in subsection (g), the deduction under this section shall not exceed $2,500, multiplied by the number of exemptions allowed for the taxable year as a deduction under section 151 (other than exemptions allowed by reason of subsection (c) or (d), relating to additional exemptions for age or blindness); except that the maximum deduction under this section shall be—

(1) $5,000, if the taxpayer is single and not the head of a household (as defined in

section 1 (b) (2)) and not a surviving spouse

(2) *Amounts taken into account.*

section 1 (b) (2)) and not a surviving spouse (as defined in section 2 (b)) or is married but files a separate return; or

(2) $10,000, if the taxpayer files a joint return with his spouse under section 6013, or is the head of a household (as defined in section 1 (b) (2)) or a surviving spouse (as defined in section 2 (b)).

(d) *Special rule for decedents*—(1) *Treatment of expenses paid after death.* For purposes of subsection (a), expenses for the medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time incurred.

(2) *Limitation.* Paragraph (1) shall not apply if the amount paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent, but this paragraph shall not apply if (within the time and in the manner and form prescribed by the Secretary or his delegate) there is filed—

(A) A statement that such amount has not been allowed as a deduction under section 2053, and

(B) A waiver of the right to have such amount allowed at any time as a deduction under section 2053.

(e) *Definitions.* For purposes of this section—

(1) The term "medical care" means amounts paid—

(A) For the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance), or

(B) For transportation primarily for and essential to medical care referred to in subparagraph (A).

(2) The determination of whether an intaxable year shall be made in accordance with dividual is married at any time during the the provisions of section 6013 (d) (relating to determination of status as husband and wife).

(f) *Exclusion of amounts allowed for care of certain dependents.* Any expense allowed as a deduction under section 214 shall not be treated as an expense paid for medical care.

(g) *Maximum limitation if taxpayer or spouse has attained age 65 and is disabled*—(1) *Special rule.* Subject to the provisions of paragraph (2), the deduction under this section shall not exceed—

(A) $15,000, if the taxpayer has attained the age of 65 before the close of the taxable year and is disabled, or if his spouse has attained the age of 65 before the close of the taxable year and is disabled and if his spouse does not make a separate return for the taxable year, or

(B) $30,000, if both the taxpayer and his spouse have attained the age of 65 before the close of the taxable year and are disabled and if the taxpayer files a joint return with his spouse under section 6013.

(2) *Amounts taken into account.* For purposes of paragraph (1)—

(A) Amounts paid by the taxpayer during the taxable year for medical care, other than amounts paid for—

(i) His medical care, if he has attained the age of 65 before the close of the taxable year and is disabled, or

(ii) The medical care of his spouse, if his spouse has attained the age of 65 before the close of the taxable year and is disabled,

shall be taken into account only to the extent that such amounts do not exceed the maximum limitation provided in subsection (c) which would (but for the provisions of this subsection) apply to the taxpayer for the taxable year;

(B) If the taxpayer has attained the age of 65 before the close of the taxable year and is disabled, amounts paid by him during the taxable year for his medical care shall be taken into account only to the extent that such amounts do not exceed $15,000; and

(C) If the spouse of the taxpayer has attained the age of 65 before the close of the taxable year and is disabled, amounts paid by the taxpayer during the taxable year for the medical care of his spouse shall be taken into account only to the extent that such amounts do not exceed $15,000.

(3) *Meaning of disabled.* For purposes of paragraph (1), an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary or his delegate may require.

(4) *Determination of status.* For purposes of paragraph (1), the determination as to whether the taxpayer or his spouse is disabled shall be made as of the close of the taxable year of the taxpayer, except that if his spouse dies during such taxable year such determination shall be made with respect to his spouse as of the time of such death.

[Sec. 213 as amended by secs. 16 and 17, Technical Amendments Act 1958 (72 Stat. 1613)]

§ 1.213–1 Medical, dental, etc., expenses.

(a) *Allowance of deduction.* (1) Section 213 permits a deduction of payments for certain medical expenses (including expenses for medicine and drugs). Except as provided in paragraph (d) of this section (relating to special rule for decedents) a deduction is allowable only to individuals and only with respect to medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. Thus, if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year.

(2) Except as provided in subparagraph (4) (i) of this paragraph, only such medical expenses (including the allowable expenses for medicine and drugs) are deductible as exceed 3 percent of the adjusted gross income for the taxable year. For the amount paid during the taxable year for medicine and drugs which may be taken into account in computing total medical expenses, see paragraph (b) of this section. For the maximum deduction allowable under section 213, see paragraph (c) of this section. As to what constitutes "adjusted gross income", see section 62 and the regulations thereunder.

(3) (i) For medical expenses paid (including expenses paid for medicine and drugs) to be deductible, they must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer and not be compensated for by insurance or otherwise. See section 152 and the regulations thereunder for definition of a dependent.

(ii) An amount excluded from gross income under section 105 (c) or (d) (relating to amounts received under accident and health plans) and the regulations thereunder shall not constitute compensation for expenses paid for medical care. Exclusion of such amounts from gross income will not affect the treatment of expenses paid for medical care.

(iii) The application of the rule allowing a deduction for medical expenses to the extent not compensated for by insurance or otherwise may be illustrated by the following example in which it is assumed that neither the taxpayer nor his wife has attained the age of 65:

Example. Taxpayer H, married to W and having one dependent child, had adjusted gross income for 1956 of $3,000. During 1956 he paid $300 for medical care, of which $100 was for treatment of his dependent child and $200 for an operation on W which was performed in September 1955. In 1956 he received a payment of $50 for health insurance to cover a portion of the cost of W's operation performed during 1955. The deduction allowable under section 213 for the calendar year 1956, provided the taxpayer itemizes his deductions and does not compute his tax under section 3 by use of the tax table, is $160, computed as follows:

Payments in 1956 for medical care	$300
Less: Amount of insurance received in 1956	50
Payments in 1956 for medical care not compensated for during 1956	250
Less: 3 percent of $3,000 (adjusted gross income)	90
Excess, allowable as a deduction for 1956	160

(4) (i) Where either the taxpayer or his spouse has attained the age of 65 before the end of the taxable year, the 3 percent limitation on the deduction for medical expenses does not apply with respect to expenses for the medical care of the taxpayer or his spouse. In such a case the taxpayer may deduct, subject to the 1–percent limitation with respect to medicine and drugs set forth in paragraph (b) of this section and subject to the maximum amount allowable as described in § 1.213–2 or paragraph (c) of this section:

(*a*) The amount of all payments for the medical care of the taxpayer and his spouse, and

(*b*) The amount by which his payments for the medical care of his dependents exceed 3 percent of his adjusted gross income.

In determining the amount described in subdivision (i) (*b*) of this subparagraph, the amount described in subdivision (i) (*a*) of this subparagraph shall not be taken into account.

(ii) For the purposes of this subparagraph, the age of a taxpayer shall be determined as of the last day of his taxable year. In the event of the taxpayer's death, the date of his death shall be the last day of his taxable year. The age of a taxpayer's spouse shall be determined as of the last day of the taxpayer's taxable year, except that, if the spouse dies within such taxable year, her age shall be determined as of the date of her death.

(iii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Taxpayer A, who attained the age of 65 on February 22, 1956, makes his return on the basis of the calendar year. During the year 1956, A had adjusted gross income of $8,000, and paid the following

medical bills: (*a*) $560 (7 percent of adjusted gross income) for the medical care of himself and his spouse, and (*b*) $160 (2 percent of adjusted gross income) for the medical care of his dependent son. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for 1956 is $560, the full amount of the medical expenses for the taxpayer and his spouse. No deduction is allowable for the amount of $160 paid for medical care of the dependent son since the amount of such payment (determined without regard to the payments for the care of the taxpayer and his spouse) does not exceed 3 percent of adjusted gross income.

Example (2). H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on August 15, 1956. The adjusted gross income of H and W in 1956 was $40,000 and they paid in such year the following amounts for medical care: (*a*) $3,000 for the medical care of H; (*b*) $2,000 for the medical care of W; and (*c*) $3,000 for the medical care of the dependent child. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for medical expenses paid in 1956 is $6,800 computed as follows:

Payments for medical care of H and W in 1956		$5,000
Payments for medical care of the dependent in 1956	$3,000	
Less: 3 percent of $40,000 (adjusted gross income)	1,200	
		1,800
Allowable deduction for 1956		6,800

(b) *Limitation with respect to medicine and drugs.* (1) Amounts paid for medicine and drugs are to be taken into account in computing the allowable deduction for medical expenses paid during the taxable year only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income for the taxable year. Thus, if the aggregate of the amounts paid for medicine and drugs exceeds 1 percent of adjusted gross income, the excess is added to other medical expenses for the purpose of computing the medical expense deduction. For definition of medicine and drugs, see paragraph (e) (2) of this section. The application of this subparagraph may be illustrated by the following example:

Example. The taxpayer, a single individual with no dependents, had an adjusted gross income of $6,000 for the calendar year 1956. During 1956, he paid a doctor $300 for medical services, a hospital $100 for hospital care, and also spent $100 for medicine and drugs. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1956 is $260, computed as follows:

Payments for medical care in 1956:		
Doctor		$300
Hospital		100
Medicine and drugs	$100	
Less: 1 percent of $6,000 (adjusted gross income)	60	
		40
Total medical expenses to be taken into account		440
Less: 3 percent of $6,000 (adjusted gross income)		180
Allowable deduction for 1956		260

(2) The 1-percent limitation rule is applicable to all taxpayers, including a taxpayer (or his spouse) who has attained the age of 65. In a case where either a taxpayer or his spouse has attained the age of 65 and the taxpayer pays an amount in excess of 1 percent of adjusted gross income for medicine and drugs for himself, his spouse, and his dependents, it is necessary to apportion the 1 percent of adjusted gross income (the portion which is not taken into account as expenses paid for medical care) between the taxpayer and his spouse on the one hand and his dependents on the other. The part of the 1 percent allocable to the taxpayer and his spouse is an amount which bears the same ratio to 1 percent of his adjusted gross income which the amount paid for medicine and drugs for the taxpayer and his spouse bears to the total amount paid for medicine and drugs for the taxpayer, his spouse, and his dependents. The balance of the 1 percent shall be allocated to his dependents. The amount paid for medicine and drugs in excess of the allocated part of the 1 percent shall be taken into account as payments for medical care for the taxpayer and his spouse on the one hand and his dependents on the other, respectively. The application of this subparagraph may be illustrated by the following example:

Example. H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on September 15, 1956. The adjusted gross income of H and W for 1956 is $10,000. During the year, H and W paid the following amounts for medical care: (i) $1,000 for doctors and hospital expenses and $180 for medicine and drugs for themselves; and (ii) $500 for doctors and hospital expenses and $140 for medicine and drugs for the dependent child. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213 (a) (2) for medical expenses paid in 1956 is $1,420, computed as follows:

H and W:			
Payments for doctors and hospital			$1,000.00
Payments for medicine and drugs		$180.00	
Less: Limitation for medicine and drugs (see computation below)		56.25	
			123.75
Medical expenses for H and W to be taken into account			1,123.75
Dependent:			
Payments for doctors and hospital		500.00	
Payments for medicine and drugs		$140.00	
Less: Limitation for medicine and drugs (see computation below)		43.75	
			96.25
Total medical expenses			596.25
Less: 3 percent of $10,000 (adjusted gross income)			300.00
Medical expenses for the dependent to be taken into account			296.25
Allowable deduction for 1956			1,420.00

Payments for medicine and drugs:	
H and W	180.00
Dependent	140.00
Total payments	320.00
Less: 1 percent of $10,000 (adjusted gross income)	100.00
Payments to be taken into account	220.00
Allocation of 1-percent exclusion:	
H and W $\frac{180}{320}\times\$100=$	56.25
Dependent $\frac{140}{320}\times\$100=$	43.75
Total	100.00

(c) *Maximum limitations.* (1) Except as provided in section 213(g) and § 1.213-2 (relating to certain aged and disabled individuals), the maximum deduction allowable for medical expenses paid in any one taxable year is the lesser of:

(i) $2,500 multiplied by the number of exemptions allowed under section 151 (exclusive of exemptions allowed under section 151 (c) for a taxpayer or spouse attaining the age of 65, or section 151 (d) for a taxpayer who is blind or a spouse who is blind);

(ii) $5,000, if the taxpayer is single, not the head of a household (as defined in section 1 (b) (2)) and not a surviving spouse (as defined in section 2 (b)), or is married and files a separate return; or

(iii) $10,000, if the taxpayer is married and files a joint return with his spouse under section 6013, or is the head of a household (as defined in section 1 (b) (2)), or a surviving spouse (as defined in section 2 (b)).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. H and W made a joint return for the calendar year 1956 and were allowed five exemptions (exclusive of exemptions under section 151 (c) or (d)), one for each taxpayer and three for their dependents. The adjusted gross income of H and W in 1956 was $40,000. They paid during such year $12,500 for medical care, no part of which is compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1956 is $10,000, computed as follows:

Payments for medical care in 1956		$12,500
Less: 3 percent of $40,000 (adjusted gross income)		1,200
Excess of medical expenses in 1956 over 3 percent of adjusted gross income		11,300

Allowable deduction for 1956 ($2,500 multiplied by 5 exemptions allowed under section 151 (b) and (e) but not in excess of $10,000) --	$10,000

(3) For the maximum deduction allowable if the taxpayer or his spouse is age 65 or over and is disabled, see § 1.213–2.

(d) *Special rule for decedents.* (1) For the purpose of section 213 (a), expenses for medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time the medical services were rendered. However, no credit or refund of tax shall be allowed for any taxable year for which the statutory period for filing a claim has expired. See section 6511 and the regulations thereunder.

(2) The rule prescribed in subparagraph (1) of this paragraph shall not apply where the amount so paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent unless there is filed in duplicate (i) a statement that such amount has not been allowed as a deduction under section 2053 in computing the taxable estate of the decedent and (ii) a waiver of the right to have such amount allowed at any time as a deduction under section 2053. The statement and waiver shall be filed with or for association with the return, amended return, or claim for credit or refund for the decedent for any taxable year for which such an amount is claimed as a deduction.

(e) *Definitions*—(1) *General.* (i) The term "medical care" includes the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for "medical care" shall include those paid for the purpose of affecting any structure or function of the body, for accident or health insurance, or for transportation primarily for and essential to medical care. Amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, or for group hospitalization and clinical care are expenses paid for medical care. However, premiums paid by a taxpayer under an insurance contract which provides reimbursement for loss of earnings due to accident or illness do not constitute amounts expended for medical care. In the case of a policy providing reimbursement for both loss of earnings and medical expenses, only the pro rata portion of such premium payments which is properly attributable to the coverage for medical expenses will constitute an expense paid for medical care.

(ii) Amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care. Amounts expended for illegal operations or treatments are not deductible. Deductions for expenditures for medical care allowable under section 213 will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for the following are payments for medical care: hospital services, nursing services (including nurses' board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, X-rays, medicine and drugs (as defined in subparagraph (2) of this paragraph, subject to the 1-percent limitation in paragraph (b) of this section), artificial teeth or limbs, and ambulance hire. However, an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.

(iii) A capital expenditure for a permanent improvement or betterment of property shall not be deductible as an expenditure for medical care, even though it may have some relation to medical care. Thus, the cost of a swimming pool, the addition of an elevator or a first floor bedroom and bath to a house for the benefit of a person unable to climb stairs, the installation of an oil burner to alleviate an allergy to coal, etc., would not be a deductible expense. A capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, shall, however, be deductible; for example, an expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc.

(iv) Expenses paid for transportation primarily for and essential to the rendition of the medical care are expenses paid for medical care. However, an amount allowable as a deduction for "transportation primarily for and essential to medical care" shall not include the cost of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a taxpayer go to a warm climate in order to alleviate a specific chronic ailment, the cost of meals and lodging while there would not be deductible. On the other hand, if the travel is undertaken merely for the general improvement of a taxpayer's health, neither the cost of transportation nor the cost of meals and lodging would be deductible. If a doctor prescribes an operation or other medical care, and the taxpayer chooses for purely personal considerations to travel to another locality (such as a resort area) for the operation or the other medical care, neither the cost of transportation nor the cost of meals and lodging (except where paid as part of a hospital bill) is deductible.

(v) The cost of in-patient hospital care (including the cost of meals and lodging therein) is an expenditure for medical care. The extent to which expenses for care in an institution other than a hospital shall constitute medical care is primarily a question of fact which depends upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services outlined in this subdivision shall be considered an institution for purposes of the rules provided herein. In general, the following rules will be applied:

(*a*) Where an individual is in an institution because his condition is such that the availability of medical care (as defined in subdivisions (i) and (ii) of this subparagraph) in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care. For example, medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term "medical care".

(*b*) Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care (as defined in subdivisions (i) and (ii) of this subparagraph) shall be considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for purposes of this section. For example, an individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention. In such case, medical care consists only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

(*c*) It is immaterial for purposes of this subdivision whether the medical care is furnished in a Federal or State institution or in a private institution.

(vi) See section 262 and the regulations thereunder for disallowance of deduction for personal, living, and family

expenses not falling within the definition of medical care.

(2) *Medicine and drugs.* The term "medicine and drugs" shall include only items which are legally procured and which are generally accepted as falling within the category of medicine and drugs (whether or not requiring a prescription). Such term shall not include toiletries or similar preparations (such as toothpaste, shaving lotion, shaving cream, etc.) nor shall it include cosmetics (such as face creams, deodorants, hand lotions, etc., or any similar preparation used for ordinary cosmetic purposes) or sundry items. Amounts expended for items which, under this subparagraph, are excluded from the term "medicine and drugs" shall not constitute amounts expended for "medical care".

(3) *Status as spouse or dependent.* In the case of medical expenses for the care of a person who is the taxpayer's spouse or dependent, the deduction under section 213 is allowable if the status of such person as "spouse" or "dependent" of the taxpayer exists either at the time the medical services were rendered or at the time the expenses were paid. In determining whether such status as "spouse" exists, a taxpayer who is legally separated from his spouse under a decree of separate maintenance is not considered as married. Thus, payments made in June 1956 by A, for medical services rendered in 1955 to B, his wife, may be deducted by A for 1956 even though, before the payments were made, B may have died or in 1956 secured a divorce. Payments made in July 1956 by C, for medical services rendered to D in 1955 may be deducted by C for 1956 even though C and D were not married until June 1956.

(f) *Exclusion of amounts allowed for care of certain dependents.* Amounts allowable under section 214 as a deduction for the care of certain dependents shall not be treated as expenses paid for medical care.

(g) *Reimbursement for expenses paid in prior years.* (1) Where reimbursement, from insurance or otherwise, for medical expenses is received in a taxable year subsequent to a year in which a deduction was claimed on account of such expenses, the reimbursement must be included in gross income in such subsequent year to the extent attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year. See section 104, relating to compensation for injuries or sickness, and section 105(b), relating to amounts expended for medical care, and the regulations thereunder, with regard to amounts in excess of or not attributable to deductions allowed.

(2) If no medical expense deduction was taken in an earlier year, for example, if the standard deduction under section 141 was taken for the earlier year, the reimbursement received in the taxable year for the medical expense of the earlier year is not includible in gross income.

(3) In order to allow the same aggregate medical expense deductions as if the reimbursement received in a subsequent year or years had been received in the year in which the payments for medical care were made, the following rules shall be followed:

(i) If the amount of the reimbursement is equal to or less than the amount which was deducted in a prior year, the entire amount of the reimbursement shall be considered attributable to the deduction taken in such prior year (and hence includible in gross income); or

(ii) If the amount of the reimbursement received in such subsequent year or years is greater than the amount which was deducted for the prior year, that portion of the reimbursement received which is equal in amount to the deduction taken in the prior year shall be considered as attributable to such deduction (and hence includible in gross income); but

(iii) If the deduction for the prior year would have been greater but for the limitations on the maximum amount of such deduction provided by section 213(c), then the amount of the reimbursement attributable to such deduction (and hence includible in gross income) shall be the amount of the reimbursement received in a subsequent year or years reduced by the amount disallowed as a deduction because of the maximum limitation, but not in excess of the deduction allowed for the previous year.

(4) The application of subparagraphs (1), (2), and (3) of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer A, a single individual (not the head of a household and not a surviving spouse) with one dependent, is entitled to two exemptions under the provisions of section 151. He had an adjusted gross income of $35,000 for the calendar year 1956. During 1956 he paid $9,000 for medical care. A received no reimbursement for such medical expenses in 1956, but in 1957 he received $6,000 upon an insurance policy covering the medical expenses which he paid in 1956. A was allowed a deduction of $5,000 (the maximum) from his adjusted gross income for 1956. The amount which A must include in his gross income for 1957 is $3,050 and the amount to be excluded from gross income for 1957 is $2,950, computed as follows:

Payments for medical care in 1956 (not reimbursed in 1956)	$9,000
Less: 3 percent of $35,000 (adjusted gross income)	1,050
Excess of medical expenses not reimbursed in 1956 over 3 percent of adjusted gross income	7,950
Allowable deduction for 1956	5,000
Amount by which the medical deductions for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957	$6,000
Less: Amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	3,050
Amount attributed to medical deduction taken for 1956	3,050
Amount to be included in gross income for 1957	3,050
Amount to be excluded from gross income for 1957 ($6,000 less $3,050)	2,950

Example (2). Assuming that A, in example (1), received $8,000 in 1957 as reimbursement for the medical expenses which he paid in 1956, the amount which A must include in his gross income for 1957 is $5,000 and the amount to be excluded from gross income for 1957 is $3,000, computed as follows:

Reimbursement received in 1957	$8,000
Less: Amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	5,050
Deduction allowable for 1956	5,000
Amount of reimbursement received in 1957 to be included in gross income for 1957 as attributable to deduction allowable for 1956	5,000
Amount to be excluded from gross income for 1957 ($8,000 less $5,000)	3,000

(h) *Substantiation of deductions.* In connection with claims for deductions under section 213, the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and date of the payment thereof in each case. If payment was made in kind, such fact shall be so reflected. Claims for deductions must be substantiated, when requested by the district director, by a statement or itemized invoice from the individual or entity to which payment for medical expenses was made showing the nature of the service rendered, and to or for whom rendered; the nature of any other item of expense and for whom incurred and for what specific purpose, the amount paid therefor and the date of the payment thereof; and by such other information as the district director may deem necessary.

§ 1.213–2 Maximum limitation on deduction if taxpayer or spouse is age 65 or over and is disabled.

(a) *In general.* For taxable years beginning after December 31, 1957, section 213(g) provides that the limitation of section 213(c) on the amount of deduction allowable for medical expenses shall not apply in certain cases. For any such taxable year, the maximum amount that is deductible under section 213 for medical expenses shall be:

(1) $15,000, if the taxpayer has attained the age of 65 before the close of the taxable year and is disabled, or

(2) $15,000, if his spouse has attained the age of 65 before the close of the taxable year and is disabled and if his spouse does not file a separate return for the taxable year, or

(3) $30,000, if both the taxpayer and his spouse have attained the age of 65 before the close of the taxable year and are disabled and if they file a joint return under section 6013.

(b) *Includible medical expenses.* (1) (i) The increased deduction provided by section 213(g) is allowable only with respect to the medical expenses of the individual who qualifies for such increased deduction. Amounts spent for the medical care of a dependent, or for the spouse of the taxpayer if she is not age 65 or over and disabled, or for the taxpayer if he is not age 65 or over and disabled, are deductible only to the extent provided by section 213(c). Thus, if amounts are spent for the medical care of an individual who does not qualify for the increased deduction provided by section 213(g), it is necessary to determine the portion of such amounts that would be deductible under section 213(c), and only such portion of such expenses is deductible.

(ii) The application of this subparagraph may be illustrated by the following example in which H and W file a joint return and have no dependents:

Example. H, who is over age 65 but not disabled, spends $6,000 for medical care for himself during the taxable year and $9,000 for the medical care of W, who is age 67 and is disabled throughout the taxable year. As a result of the application of the provisions of this paragraph and section 213(c), H would be entitled to a deduction of $5,000 for expenses paid for his own medical care, while under section 213(g) he would be allowed a deduction of $9,000 for the medical care of W, a total of $14,000.

(2) Amounts paid for the medical care of an individual who qualifies for the increased deduction provided by section 213(g) are deductible only to the extent such amounts do not exceed $15,000. For example, if both the taxpayer and his spouse were age 65 or over and disabled, and the taxpayer paid $20,000 for medical care for himself, and $5,000 for medical care for his spouse, the maximum deduction allowable on a joint return would be $20,000 ($15,000 for the taxpayer and $5,000 for his spouse).

(3) Except as provided in section 213(b) and paragraph (b) of § 1.213–1, all amounts paid during the taxable year for the medical care of an individual who qualifies for the increased deduction provided by section 213(g) are deductible to the extent provided in such section. See paragraph (a)(4)(i) of § 1.213–1. For example, an individual who files his income tax return on the basis of a calendar year, and who is age 70 and becomes disabled in September, may, in determining his increased deduction under section 213(g), include all amounts which he paid during the taxable year for his medical care (except to the extent limited by section 213(b) and paragraph (b) of § 1.213–1), irrespective of whether the amounts are paid in connection with the disability which qualifies him for the increased deduction, or whether they were paid in connection with another illness.

(c) *Meaning of disabled.* (1) An individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 213(g) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose). For purposes of section 213 (g), housekeeping shall be considered the substantial gainful activity of an individual whose primary activity is housekeeping.

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

(i) Loss of use of two limbs;

(ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;

(iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;

(iv) Cancer which is inoperable and progressive;

(v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;

(vi) Mental diseases (e.g., psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;

(vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;

(viii) Permanent and total loss of speech;

(ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 213(g). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 213(g), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. Indefinite is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 213(g). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

(d) *Manner of proving the existence of disability.* (1) Any taxpayer whose medical expenses are in excess of the maximum limitations of section 213(c) and who seeks to apply the provisions of section 213(g) must submit the information required by paragraph (h) of § 1.213–1 and must establish that he or his spouse, as the case may be, has sustained an impairment as described in paragraph (c) of this section and that by reason of such impairment, he or his spouse, as the case may be, is unable, with his training, education, and work experience, to engage in his customary or any comparable substantial gainful activity, within the meaning of paragraph (c) of this section.

(2) For the first taxable year for which the taxpayer seeks to apply section 213(g) in regard to an individual, there must be submitted with his income tax return a doctor's statement as to the impairment of such individual upon which the taxpayer relies. There must also be submitted with the return a statement by the taxpayer with respect to the effect of the impairment upon such individual's substantial gainful activity. For subsequent taxable years, the taxpayer may, in lieu of such statements with respect to such individual, submit a statement declaring the continued existence (without substantial diminution) of the impairment and its continued effect upon the substantial gainful activity.

(e) *Determination of status.* (1) For purposes of this section, the determination as to whether a taxpayer or his spouse is disabled shall be made as of

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the close of the taxable year. Thus, if the taxpayer or his spouse is disabled as of the close of the taxpayer's taxable year, the individual concerned shall be considered disabled for the entire taxable year. If the taxpayer's spouse dies during the taxpayer's taxable year, the determination as to whether she is disabled for such taxable year shall be made as of the date of her death. However, if the disability of the taxpayer or his spouse terminates during the taxable year of the taxpayer, the individual concerned shall not be considered disabled for purposes of this section.

(2) For purposes of this section, the age of a taxpayer or his spouse shall be determined in accordance with the rules stated in paragraph (a)(4)(ii) of § 1.213–1.

§ 1.214 Statutory provisions; expenses for care of certain dependents.

SEC. 214. *Expenses for care of certain dependents*—(a) *General rule.* There shall be allowed as a deduction expenses paid during the taxable year by a taxpayer who is a woman or a widower for the care of one or more dependents (as defined in subsection (c) (1)), but only if such care is for the purpose of enabling the taxpayer to be gainfully employed.

(b) *Limitations*—(1) *In general.* The deduction under subsection (a)—

(A) Shall not exceed $600 for any taxable year; and

(B) Shall not apply to any amount paid to an individual with respect to whom the taxpayer is allowed for his taxable year a deduction under section 151 (relating to deductions for personal exemptions).

(2) *Working wives.* In the case of a woman who is married, the deduction under subsection (a)—

(A) Shall not be allowed unless she files a joint return with her husband for the taxable year, and

(B) Shall be reduced by the amount (if any) by which the adjusted gross income of the taxpayer and her spouse exceeds $4,500.

This paragraph shall not apply if the taxpayer's husband is incapable of self-support because mentally or physically defective.

(c) *Definitions.* For purposes of this section—

(1) *Dependent.* The term "dependent" means a person with respect to whom the taxpayer is entitled to an exemption under section 151 (e) (1)—

(A) Who has not attained the age of 12 years and who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer; or

(B) Who is physically or mentally incapable of caring for himself.

(2) *Widower.* The term "widower" includes an unmarried individual who is legally separated from his spouse under a decree of divorce or of separate maintenance.

(3) *Determination of status.* A woman shall not be considered as married if she is legally separated from her spouse under a decree of divorce or of separate maintenance at the close of the taxable year.

§ 1.214–1 Expenses for the care of certain dependents.

(a) *General rule.* Section 214 allows a deduction from gross income of expenses paid for the care of certain dependents where the care is for the purpose of enabling the taxpayer to be gainfully employed. Such expenses are referred to in this section as "child care" expenses. The deduction may not exceed $600 for any taxable year (regardless of the number of dependents for whose care the expenses are paid) and is allowed only for expenses incurred while the taxpayer is gainfully employed or in active search of gainful employment. The employment which is the cause of the incurring of the expenses may, however, consist of services either within or without the home of the taxpayer. Self-employment constitutes employment for purposes of section 214.

(b) *Taxpayers who may qualify for the deduction.* The deduction provided in section 214 is allowed only to a woman or a widower. For the purpose of this paragraph, the following rules apply:

(1) *A widower.* The deduction is allowed for expenses paid by a taxpayer who is a widower at the time the expenses are incurred. The term "widower" includes (i) a man whose wife has died and who has not remarried, (ii) a man who is divorced from his wife and has not remarried, and (iii) a man who is legally separated from his wife under a decree of legal separation.

(2) *A married woman whose husband is capable of self-support.* If the expenses are paid by a woman (i) who is married at the time the expenses are incurred, (ii) whose husband at that time is not incapable of self-support because he is mentally defective or physically disabled, and (iii) who is not divorced or legally separated at the end of the taxable year, the deduction is allowed, but only if she files a joint income tax return with her husband for the taxable year in which the expenses are paid. Further, the amount otherwise deductible shall be reduced by the amount, if any, by which the combined adjusted gross income of the taxpayer and her spouse exceeds $4,500 for the taxable year in which the expenses are paid. The amount otherwise deductible is the amount expended for child care or $600, whichever is lesser. The determination of whether the taxpayer's husband is incapable of self-support because of a mental defect or physical disability shall be made without regard to his income from sources other than his own earnings. For purposes of this subparagraph, the term "earnings" means wages, salaries, commissions, professional fees, and other amounts received as compensation for personal services actually rendered. It does not include income such as pensions, annuities, sick-pay, interest, dividends, or rents.

(3) *A married woman whose husband is incapable of self-support.* (i) The deduction is allowed without regard to the limitations described in subparagraph (2) of this paragraph for expenses paid by a married woman whose husband is incapable of self-support because he is mentally defective or physically disabled (as defined in subparagraph (2) of this paragraph) at the time the expenses are incurred.

(ii) A married woman claiming a deduction under this subparagraph shall attach to her income tax return in which the deduction is claimed a statement disclosing (*a*) the nature of her husband's disability, (*b*) the period of the disability, and (*c*) if her husband had earnings during the period, the amount of such earnings. Where the husband is capable of self-support for part of a taxable year the child care expenses incurred for such part shall be treated under subparagraph (2) of this paragraph. See example (8) of paragraph (c) of this section.

(4) *A single woman.* The deduction is also allowed without regard to the limitation described in subparagraph (2) of this paragraph for expenses paid by a woman who (i) is unmarried at the time the expenses are incurred, or (ii) is, at the close of her taxable year, legally separated from her husband under a decree of divorce or of separate maintenance.

(5) *Determination of status.* If child care expenses are incurred in one taxable year and paid in another, the status of a taxpayer described in subparagraphs (1) to (4) of this paragraph, inclusive, shall be determined as of the year in which the expenses are incurred and not when such expenses are paid.

(c) *Computation of deduction.* The deduction for child care expenses is allowable only with respect to such expenses actually paid during the taxable year regardless of when the event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. If child care expenses are incurred but not paid during the taxable year, no deduction can be taken for such year. Thus, if an expenditure was incurred in December 1955, but not paid until January 1956, no deduction may be taken for the calendar year 1955. The following examples illustrate the computation of the deduction allowed by section 214 in the case of a taxpayer making his return on the basis of the calendar year. In each example it is assumed that the expenses are of the type which would qualify for the deduction.

Example (1). M was a widower during 1954, until September 1, when he remarried. He paid $50 each month in 1954 for child care expenses. He may take into account, for purposes of the deduction allowed by section 214, only the expenses paid during the taxable year which were incurred while he was unmarried. Since the expenses were $400 ($50 per month from January to August, inclusive), the amount of the deduction is $400. If M had paid $100 per month during 1954, the deduction would be limited to $600, although the expenses incurred while M was unmarried amount to $800.

Example (2). H and W were married during the entire year 1954. W, the wife, paid $900 for child care expenses incurred during the year. The combined adjusted gross income of H and W for 1954 was $5,000. The allowable deduction under section 214 is $100 ($600, the maximum deduction allowable, reduced by $500, the excess of adjusted gross income of $5,000 over $4,500). The deduction of $100 is allowable only if H and W made a joint return for 1954.

Example (3). The facts are the same as in example (2), except that the child care expenses paid during the year were $400. No deduction is allowable under section 214, since the amount of expenses paid, $400, is less than $500 (the excess of the adjusted gross income over $4,500).

Example (4). During 1954, W, a woman, paid $50 each month for child care expenses. She was unmarried until April 1, 1954, and was married for the remainder of the year. H, her husband, was capable of self-support.

Thus, if the taxpayer, a working widow,

a reasonable allocation shall be made

and the combined adjusted gross income of husband and wife was $4,700. H and W made a joint return for 1954. The total deduction allowable to W under section 214 is $400, computed as follows: $150 as expenses incurred while W was a single woman, and $250 as expenses incurred while W was married; the $250 is arrived at by taking the amount expended while H and W were married, $450, and reducing it by $200 (the excess of adjusted gross income, $4,700 over $4,500).

Example (5). The facts are the same as in example (4), except that the amounts paid are $75 per month ($225 being paid for expenses incurred while W was single and $675 while she was married). The total allowable deduction in this case is $600. $225 is deductible as expenses incurred while W was a single woman. $400 of the expenses incurred during the period of marriage is also deductible. However, the maximum deduction allowable to W is $600. The allowable amount for expenses incurred during the period of marriage is determined as follows: $675 (the amount expended during the period) is reduced to $600 (the maximum deduction allowable) and $600 is then reduced by $200 (the excess of adjusted gross income $4,700 over $4,500) to $400.

Example (6). H and W were married during 1954 prior to July 1, when they received a decree of divorce. She did not remarry during 1954. W paid $100 per month for child care expenses during 1954. The allowable deduction is $600. Since W is considered to have been a single woman during all of 1954, the limitations with respect to the deduction allowed to a married woman are not applicable, and only the $600 limitation applies.

Example (7). H and W married on July 1, 1954. At all times in 1954, until July 1, H was a widower and W was a widow. H and W each paid $750 for child care in 1954, prior to their marriage. Each is allowed a deduction for 1954 of $600, regardless of their adjusted gross income and of the amount of their child care expenditures while married, and whether or not a joint return was filed. However, no additional deduction would be allowed for child care expenses paid after their marriage.

Example (8). H and W were married at all times during the year 1954. As a result of an accident, H incurred injuries which rendered him incapable of self-support during 1954 until September 1. The adjusted gross income of H and W for 1954 was $4,700. W paid $60 each month in 1954 for child care expenses. The deduction allowable to W by section 214 is $520. This amount is composed of $480, representing the amounts paid during H's period of disability, and $40, representing the allowable deduction of expenses paid in the amount of $240 from September to December, inclusive ($240 is reduced by $200, the excess of the adjusted gross income ($4,700) over $4,500).

Example (9). H and W were married from January 1, 1954 to October 1, 1954, when H died. The combined adjusted gross income of the spouses was $4,800. W paid $50 per month for child care expenses throughout the entire year. The deduction allowed to W if she filed a separate return is $150, the amount paid while she was a widow. If a joint return is filed on behalf of the widow and her deceased husband, the deduction allowable is $300 which includes $150 deductible as a married woman (the amount expended during marriage, $450, being reduced by $300, the excess of $4,800 over $4,500).

(d) *Dependents.* (1) The deduction provided by section 214 is allowed only for expenses paid for the care of an individual who (for the taxable year of the taxpayer in which the expenses are incurred) is a dependent of the taxpayer for whom an exemption is allowed under section 151 (e) (1). Furthermore, the dependent must, at the time the expenses are incurred, be either—

(i) Under the age of 12 years, or

(ii) Physically or mentally unable to care for himself. It is not necessary that the dependent be permanently disabled in order for the amount expended for his care to be deductible. However, the mere fact that the disability, whether temporary or permanent, renders him incapable of self-support does not necessarily mean that he is incapable of self-care within the meaning of this subdivision. The deduction for expenses paid for the care of a dependent under the age of 12 years is allowed even though the dependent is not a child or stepchild of the taxpayer.

(2) The rules provided in sections 151 and 152, with respect to the definition and qualification of an individual as a dependent, govern for the purpose of section 214. Thus, expenses for the care of a child or stepchild of the taxpayer under 12 whom the taxpayer supports are deductible even though the child or stepchild has gross income of $600 or more. On the other hand, expenses for the care of an aged parent would not be deductible if the gross income condition of section 151 (e) (1) (A) is not met. The term "dependent" does not include the spouse of a taxpayer.

(e) *Payments to a dependent.* No deduction is allowed under section 214 for expenses paid to an individual for whom the taxpayer is allowed, for the taxable year in which the expenses are paid, an exemption under section 151. Thus, if the taxpayer, a working widow, supports her mother and is entitled to claim her as a dependent, she may not deduct amounts paid to the mother for the care of the taxpayer's children.

(f) *What expenses are deductible—*(1) *In general.* In order for an expense to be deductible under section 214, it must meet three conditions: First, the expense must be for the care of a dependent; second, it must be for a dependent's care while the taxpayer is gainfully employed or in search of gainful employment; and third, the expense must be for the purpose of enabling the taxpayer to be gainfully employed. In determining whether an expense meets these conditions, all the facts and circumstances of the case must be taken into consideration.

(2) *Definition of care of a dependent.* (i) In general, the phrase "expenses for the care of a dependent" means amounts expended for the primary purpose of assuring the dependent's well being and protection. It does not include all benefits which may be bestowed upon him. Accordingly, amounts expended to provide food, clothing, or education, are not, in themselves, amounts expended for "care" so as to be deductible under section 214. However, where the manner of providing care is such that the expense which must be incurred includes payments for other benefits which are inseparably a part of the care, the full amount of the expense will be considered to be incurred for care. Thus, the full amount paid to a nursery school will be considered to be for the care of the child, even though the school also furnishes lunch, recreational activities, and other benefits.

(ii) The manner of providing the care need not be the least expensive method available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to afford the taxpayer's child adequate care. Regardless of this fact, the expense incurred for the child at a nursery school or day camp may be expense for the care of the child. See, however, subparagraph (4) of this paragraph with respect to the requirement that the expense must be for the purpose of enabling the taxpayer to be gainfully employed.

(iii) Where a portion of an expenditure is for the care of a dependent and a portion is for other unrelated purposes, a reasonable allocation shall be made and only the portion of the amount paid which is attributable to the care shall be considered an amount to which section 214 is applicable. This rule is applicable if, for example, a servant performs household duties and also cares for the children of the taxpayer. In this case, however, where one of the children is under 12, and the other (or others) is over 12, there need be no further allocation between the children under 12 years and those over that age.

(3) *Period of employment.* Since the deduction is allowed only for expenses for care for those periods during which the taxpayer is gainfully employed (or in active search of gainful employment), an allocation may be required when an expense covers periods of care in which no employment is involved. Thus, if a taxpayer pays $50 each month during the year for care of his child at a foster home, and the taxpayer is employed (or in search of employment) for only two months during the year, the deduction is limited to $100.

(4) *Purpose of expenditure.* Even if an expense is incurred for the care of a dependent, it is not deductible unless it is incurred for the purpose of permitting the taxpayer to be gainfully employed. Whether that is the true purpose of the expense depends upon the facts and circumstances of the particular case. Thus, the fact that the cost of providing care for a dependent is greater than the amounts anticipated to be received from the employment of the taxpayer may indicate that the purpose of the expenditure is other than to permit the taxpayer to be gainfully employed.

(5) *Examples.* The following examples illustrate the application of this paragraph:

Example (1). A widow has a child who is too young to attend public school. In order that she may be gainfully employed, the widow places the child in a nursery school while she is at work. The expenses paid to the nursery school are child care expenses to which the deduction under section 214 is applicable. Assuming the nursery school provides lunch for the child, no allocation is required between that part of the expense which might be considered to be for the lunch as distinguished from the expense of assuring the child's protection.

Example (2). The taxpayer, a single woman, in order to be gainfully employed employs a housekeeper who cares for the taxpayer's two children, aged 9 and 13 years,

respectively, in addition to performing regular household duties of cleaning and cooking. If it is assumed that the compensation paid to the housekeeper is $1,200 during the year, and that $500 is allocated to the care of the children, a deduction of $500 is allowed under section 214. No allocation is required for purposes of determining which part of the $500 is for the care of the 9 year old child. If the expenses allocable to the care of the children were $700, the amount of the deduction would be $600, the maximum amount allowable in a taxable year under section 214.

Example (3). The taxpayer, a single woman, has a dependent grandchild 10 years of age who has been attending public school. The taxpayer who has been working part time is offered a position involving full-time employment which she can accept only if arrangements are made for the care of the child from 8 a. m. to 5:30 p. m. Such arrangements are made at a private school to which she sends the child. The expenses paid to the school are for the care of the child without allocation between that part of the expense which represents tuition and that part which represents true care. The expense is considered to be incurred for the purpose of enabling the taxpayer to be gainfully employed.

Example (4). The taxpayer, a widow with a substantial income, has a child aged 11 who has been attending boarding school for several years. The taxpayer, who has been performing gratuitous services for a philanthropic organization, accepts a part-time job with the organization for which she is paid a small salary. From these facts it would appear that the expense of continuing the child in the boarding school is not for the purpose of enabling the taxpayer to be gainfully employed, whether or not the expense is considered to be incurred for the care of the child.

Example (5). The taxpayer, a widower, has a child who is physically incapable of caring for himself. In order to be gainfully employed the taxpayer sends the child to a school for children who are physically handicapped. The expense of the school, whether a day school or a boarding school, is a child care expense.

Example (6). The taxpayer, a single woman, lives with her mother who is an invalid incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother while the taxpayer is at work. The expense paid to the nurse may be a "child care" expense.

(g) *Expenses qualifying under section 213.* (1) An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also, as in example (6) of paragraph (f) of this section, constitute an expense for which a deduction is allowable under section 214. In such a case, that part of the amount for which a deduction is allowed under section 214 shall not be treated as an expense under section 213.

(2) On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it shall not be allowed as a deduction under section 214.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). W, a single woman, pays $720 during the taxable year for the care of her child who suffers from infantile paralysis. It is assumed that the expenses are of a nature which qualify as medical expenses under section 213. It is also assumed that these expenses are for the purpose of permitting W to be gainfully employed. W's adjusted gross income for the taxable year is $5,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance of the expenses, or $120, she treats as medical expenses. However, this amount does not exceed 3 percent of her adjusted gross income and is thus not allowable as a deduction under section 213.

Example (2). It would not be proper in the case presented in (1) for W first to determine under section 213 her deductible medical expenses (which would be $570 ($720 less 3% x $5,000)), and then claim as a deduction under section 214 the $150 which is not deductible under section 213. The $150 would be disallowed under section 214 for the reason that it was treated as a medical expense in determining the amount deductible under section 213.

Example (3). W, a single woman under the age of 65 years, is also the head of a household. She pays $12,000 during the taxable year for child care expenses which also qualify as medical expenses under section 213. W's adjusted gross income for the taxable year is $18,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance, or $11,400, is treated as medical expenses. The allowable deduction under section 213 for such expenses is the excess of 3 percent of W's adjusted gross income, or $10,860, but subject to the maximum limitation in section 213.

§ 1.215 Statutory provisions; alimony, etc., payments.

SEC. 215. *Alimony, etc., payments*—(a) *General rule.* In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71 (d) or 682, the amount thereof is not includible in the husband's gross income.

(b) *Cross reference.* For definitions of "husband" and "wife", see section 7701 (a) (17).

§ 1.215–1 Periodic alimony, etc., payments.

(a) A deduction is allowable under section 215 with respect to periodic payments in the nature of, or in lieu of, alimony or an allowance for support actually paid by the taxpayer during his taxable year and required to be included in the income of the payee wife or former wife, as the case may be, under section 71. As to the amounts required to be included in the income of such wife or former wife, see section 71 and the regulations thereunder. For definition of "husband" and "wife" see section 7701 (a) (17).

(b) The deduction under section 215 is allowed only to the obligor spouse. It is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse. The obligor spouse, however, is not allowed a deduction for any periodic payment includible under section 71 in the income of the wife or former wife, which payment is attributable to property transferred in discharge of his obligation and which, under section 71 (d) or section 682, is not includible in his gross income.

(c) The following examples, in which both H and W file their income tax returns on the basis of a calendar year, illustrate cases in which a deduction is or is not allowed under section 215:

Example (1). Pursuant to the terms of a decree of divorce, H, in 1956, transferred securities valued at $100,000 in trust for the benefit of W, which fully discharged all his obligations to W. The periodic payments made by the trust to W are required to be included in W's income under section 71. Such payments are stated in section 71 (d) not to be includible in H's income and, therefore, under section 215 are not deductible from his income.

Example (2). A decree of divorce obtained by W from H incorporated a previous agreement of H to establish a trust, the trustees of which were instructed to pay W $5,000 a year for the remainder of her life. The court retained jurisdiction to order H to provide further payments if necessary for the support of W. In 1956 the trustee paid to W $4,000 from the income of the trust and $1,000 from the corpus of the trust. Under the provisions of sections 71 and 682 (b), W would include $5,000 in her income for 1956. H would not include any part of the $5,000 in his income nor take a deduction therefor. If H had paid the $1,000 to W pursuant to court order rather than allowing the trustees to pay it out of corpus, he would have been entitled to a deduction of $1,000 under the provisions of section 215.

(d) For other examples, see sections 71 and 682 and the regulations thereunder.

§ 1.216 Statutory provisions; amounts representing taxes and interest paid to cooperative housing corporation.

SEC. 216. *Amounts representing taxes and interest paid to cooperative housing corporation*—(a) *Allowance of deduction.* In the case of a tenant-stockholder (as defined in subsection (b) (2)), there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of—

(1) The real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation on the houses or apartment building and on the land on which such houses (or building) are situated, or

(2) The interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation on its indebtedness contracted—

(A) In the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building, or

(B) In the acquisition of the land on which the houses (or apartment building) are situated.

(b) *Definitions.* For purposes of this section—

(1) *Cooperative housing corporation.* The term "cooperative housing corporation" means a corporation—

(A) Having one and only one class of stock outstanding,

(B) Each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) No stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

a particular apartment in the building for a

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(2) *Tenant-stockholder.* The term "tenant-stockholder" means an individual who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy.

(3) The term "tenant-stockholder's proportionate share" means that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation (including any stock held by the corporation).

§ 1.216–1 Amounts representing taxes and interest paid to cooperative housing corporation.

(a) *General rule.* A tenant-stockholder may deduct from his gross income amounts paid or accrued within his taxable year to a cooperative housing corporation representing certain taxes or interest paid or incurred by the corporation. Such amounts are not allowable as a deduction unless they represent the tenant-stockholder's proportionate share of—

(1) The real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on the houses (or apartment building) and the land on which the houses (or apartment building) are situated, or

(2) The interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses (or apartment building), or in the acquisition of the land on which the houses (or apartment building) are situated.

(b) *Limitation.* The deduction allowable under section 216 shall not exceed the amount of the tenant-stockholder's proportionate share of the taxes and interest described therein. In case a tenant-stockholder pays or incurs all or a part of his proportionate share of such taxes and interest to the corporation, the amount so paid or incurred which represents taxes and interest is allowable as a deduction if the requirements of section 216 are otherwise satisfied. As used in this section, the tenant-stockholder's proportionate share is that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including any stock held by the corporation. If a tenant-stockholder pays or incurs to the corporation an amount on account of such taxes and interest and other items, such as maintenance, overhead expenses, and curtailment of mortgage indebtedness, the amount representing such taxes and interest is an amount which bears the same ratio to the total amount of the tenant-stockholder's payment or liability, as the case may be, as the total amount of the tenant-stockholder's proportionate share of such taxes and interest bears to the total amount of the tenant-stockholder's proportionate share of the taxes, interest, and other items on account of which such payment is made or liability incurred. No deduction is allowable under section 216 for such part of amounts representing the taxes or interest described in that section as is deductible by a tenant-stockholder under any other provision of the Code.

(c) *Cooperative housing corporation*—(1) *One class of stock.* In order to qualify as a "cooperative housing corporation" under section 216, the corporation shall have one and only one class of stock outstanding. However, a special classification of preferred stock, in a nominal amount not exceeding $100, issued to a Federal housing agency or other governmental agency solely for the purpose of creating a security device on the mortgage indebtedness of the corporation, will not be considered as a "class of stock" within the meaning of section 216.

(2) *Right of occupancy.* Each stockholder of the corporation must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reason of his ownership of stock in the corporation, that is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial.

(3) *Distributions.* None of the stockholders of the corporation may be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings or profits of the corporation.

(4) *Gross income.* It is a prerequisite to the allowance of a deduction under section 216 that at least 80 percent of the gross income of the corporation for the taxable year of the corporation in which the taxes and interest are paid or incurred is derived from tenant-stockholders.

(d) *Tenant-stockholder.* The term "tenant-stockholder" means an individual who is a stockholder in a cooperative housing corporation, as defined in section 216, and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the district director as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the building and the land on which it is situated which is attributable to the apartment or housing unit which such individual is entitled to occupy.

(e) *Examples.* The application of section 216 may be illustrated by the following examples, which refer to apartments but which are equally applicable to housing units:

Example (1). The X Corporation is, and at all times since 1957 has been, a cooperative housing corporation within the meaning of section 216. In 1957 it purchased a site and constructed thereon a building with 10 apartments at a total cost of $200,000. The fair market value of the land and building was likewise $200,000 at the time of completion of the building. Each apartment is of equal value. Upon completion of the building, the X Corporation mortgaged the land and building for $100,000, and sold its total authorized capital stock, consisting of 1,000 shares of common stock, for $100,000. The stock was purchased by 10 individuals, each of whom paid $10,000 for 100 shares. Each certificate for 100 shares provides that the holder thereof is entitled to a lease of a particular apartment in the building for a specified term of years. Each lease provides that the lessee shall pay his proportionate part of the corporation's expenses. In 1957 the original owner of 100 shares of the common stock of the X Corporation and of the lease to apartment No. 1 made a gift of the stock and lease to A, an individual. The taxable year of A and of the X Corporation is the calendar year. The corporation computes its taxable income on an accrual method, while A computes his taxable income on the cash receipts and disbusements method. In 1958 the X Corporation incurred expenses aggregating $13,800, namely, $4,000 for the real estate taxes on the land and building, $5,000 for the interest on the mortgage, $3,000 for the maintenance of the building, and $1,800 for other expenses. In 1959, A pays the X Corporation $1,380, representing his proportionate part of the expenses incurred by the corporation. The entire gross income of the X Corporation for 1958 was derived from tenant-stockholders. A is entitled under section 216 to a deduction of $900 in computing his taxable income for 1959. The deduction is computed as follows:

Shares of stock of X Corporation owned by A		100
Shares of stock of X Corporation owned by 9 other tenant-stockholders		900
Total shares of stock of X Corporation outstanding		1,000
Proportion of outstanding stock of X Corporation owned by A		1/10
Expenses incurred by X Corporation:		
Real estate taxes	$4,000	
Interest	5,000	
Maintenance	3,000	
Other expenses	1,800	
		$13,800
Amount paid by A representing his proportionate part of such expenses (1/10 of $13,800)	$1,380	
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900	
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380	
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,380)	900	
A's allowable deduction	900	

Since the stock which A acquired by gift was fully paid up by his donor in an amount equal to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in

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the land and building which is attributable to apartment No. 1, the requirement of section 216 in this regard is satisfied. The fair market value at the time of the gift of the corporation's equity attributable to the apartment is immaterial.

Example (2). The facts are the same as in example (1) except that the building constructed by the X Corporation contained, in addition to the 10 apartments, business space on the ground floor, which the corporation rented at $2,400 for the calendar year 1958. The corporation deducted the $2,400 from its expenses in determining the amount of the expenses to be prorated among its tenant-stockholders. The amount paid by A to the corporation in 1959 is $1,140 instead of $1,380. More than 80 percent of the gross income of the corporation for 1958 was derived from tenant-stockholders. A is entitled under section 216 to a deduction of $743.48 in computing his taxable income for 1959. The deduction is computed as follows:

Expenses incurred by X Corporation	$13,800.00
Less: Rent from business space	2,400.00
Expenses to be prorated among tenant-stockholders	11,400.00
Amount paid by A representing his proportionate part of such expenses (1/10 of $11,400)	1,140.00
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,140)	743.48
A's allowable deduction	743.48

Since the portion of A's payment allocable to real estate taxes and interest is only $743.48, that amount instead of $900 is allowable as a deduction in computing A's taxable income for 1959.

Example (3). The facts are the same as in example (2) except that the amount paid by A to the X Corporation in 1959 is $1,000 instead of $1,140. A is entitled under section 216 to a deduction of $652.17 in computing his taxable income for 1959. The deduction is computed as follows:

Total amount paid by A	$1,000.00
A's proportionate part of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate part of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,000)	$652.17
A's allowable deduction	652.17

Since the portion of A's payment allocable to real estate taxes and interest is only $652.17, that amount instead of $900 is allowable as a deduction in computing A's taxable income for 1959.

§ 1.217 Statutory provisions; cross references.

SEC. 217. *Cross references.* (1) For deduction for long-term capital gains in the case of a taxpayer other than a corporation, see section 1202.

(2) For deductions in respect of a decedent, see section 691.

SPECIAL DEDUCTIONS FOR CORPORATIONS

§ 1.241 Statutory provisions; allowance of special deductions.

SEC. 241. *Allowance of special deductions.* In addition to the deductions provided in part VI (sec. 161 and following), there shall be allowed as deductions in computing taxable income the items specified in this part.

§ 1.241–1 Allowance of special deductions.

A corporation, in computing its taxable income, is allowed as deductions the items specified in part VIII (section 242 and following), subchapter B, chapter 1 of the Code, in addition to the deductions provided in part VI (section 161 and following) subchapter B, chapter 1 of the Code.

§ 1.242 Statutory provisions; partially tax-exempt interest.

SEC. 242. *Partially tax-exempt interest*—(a) *Allowance of deduction.* There shall be allowed to a corporation as a deduction the amount received as interest on obligations of the United States or on obligations of corporations organized under Act of Congress which are instrumentalities of the United States, but only if—

(1) Such interest is included in gross income; and

(2) Such interest is exempt from normal tax under the Act authorizing the issuance of such obligations.

(b) *Cross reference.* For reduction of deduction under subsection (a) on account of amortizable bond premium, see section 171.

§ 1.242–1 Deduction for partially tax-exempt interest.

A corporation is allowed a deduction under section 242(a) in an amount equal to certain interest received on obligations of the United States, or on obligations of corporations organized under acts of Congress which are instrumentalities of the United States. The interest for which a deduction shall be allowed is interest which is included in gross income and which is exempt from normal tax under the act, as amended and supplemented, which authorized the issuance of the obligations.

§ 1.243 Statutory provisions; dividends received by corporations.

SEC. 243. *Dividends received by corporations*—(a) *General rule.* In the case of a corporation (other than a small business investment company operating under the Small Business Investment Act of 1958), there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends (other than dividends described in paragraph (1) of section 244, relating to dividends on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter.

(b) *Small business investment companies.* In the case of a small business investment company operating under the Small Business Investment Act of 1958, there shall be allowed as a deduction an amount equal to 100 percent of the amount received as dividends (other than dividends described in paragraph (1) of section 244, relating to dividends on preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter.

(c) *Special rules for certain distributions.* For purposes of subsections (a) and (b)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subjec to the limitations prescribed in section 854.

[Sec. 243 as amended by sec. 57(b), Technical Amendments Act 1958 (72 Stat. 1645)]

§ 1.243–1 Deduction for dividends received by corporations.

(a)(1) A corporation is allowed a deduction under section 243 for dividends received from a domestic corporation which is subject to taxation under chapter 1 of the Internal Revenue Code of 1954.

(2) Except as provided in section 243 (c) and in section 246, the deduction is:

(i) For the taxable year, an amount equal to 85 percent of the dividends received from such domestic corporations during the taxable year (other than dividends to which subdivision (ii) of this subparagraph applies).

(ii) For a taxable year beginning after September 2, 1958, an amount equal to 100 percent of the dividends received from such domestic corporations if at the time of receipt of such dividends the taxpayer corporation is a Federal licensee under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B). However, to claim the deduction provided by section 243(b) the company must file with its return a statement that it was a Federal licensee under the Small Business Investment Act of 1958 at the time of the receipt of the dividends.

(3) To determine the amount of the distribution to a recipient corporation and the amount of the dividend, see §§ 1.301–1 and 1.316–1.

(b) The deductions allowed by section 243 (a) and (b) shall be determined without regard to any dividends described in paragraph (1) of section 244 (relating to dividends on the preferred stock of a public utility). That is, such deductions shall be determined without regard to any dividends received on the preferred stock of a public utility which is subject to taxation under chapter 1 of the Code and with respect to which a deduction is allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities). For a deduction with respect to such dividends received on the preferred stock of a public utility, see section 244. If a deduction for dividends paid is not allowable to the distributing corporation under section 247 with respect to the dividends on its preferred stock, such dividends received from a domestic public utility corporation subject to taxation under chapter 1 of the Code are includible in determining the deduction allowed by section 243 (a) or (b).

(c) For limitation of dividends received deduction, see section 246 and the regulations thereunder.

§ 1.243–2 Special rules for certain distributions.

(a) *Dividends paid by mutual savings banks, etc.* In determining the deduction provided in section 243 (a) or (b), any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, cooperative banks, and domestic building and loan associations) shall not be considered as a dividend.

(b) *Dividends received from regulated investment companies.* In determining

the deduction provided in section 243 (a) or (b), dividends received from a regu- public utility corporation which is subject to taxation under chapter of the dividends received out

the deduction provided in section 243 (a) or (b) dividends received from a regulated investment company shall be subject to the limitations provided in section 854.

§ 1.244 Statutory provisions; dividends received on certain preferred stock.

SEC. 244. *Dividends received on certain preferred stock.* In the case of a corporation, there shall be allowed as a deduction an amount computed as follows:

(1) First determine the amount received as dividends on the preferred stock of a public utility which is subject to taxation under this chapter and with respect to which the deduction provided in section 247 for dividends paid is allowable.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) The numerator of which is 14 percent, and

(B) The denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(3) Finally ascertain the amount which is 85 percent of the excess of—

(A) The amount determined under paragraph (1), over

(B) The amount determined under paragraph (2).

§ 1.244–1 Deduction for dividends received on certain preferred stock.

A corporation is allowed a deduction under section 244 for dividends received on certain preferred stock of certain public utility corporations subject to taxation under chapter 1 of the Code. The deduction is allowable only for dividends received on the preferred stock of a public utility with respect to which the deduction for dividends paid provided in section 247 (relating to dividends paid on certain preferred stock of public utilities) is allowable to the distributing corporation.

§ 1.244–2 Computation of deduction.

(a) Section 244 provides a specific rule for the computation of the deduction for dividends received on the preferred stock of a public utility. The deduction computed under section 244 is subject to the limitation provided in section 246.

(b) The computation of the deduction provided in section 244 may be illustrated by the following examples:

Example (1). Corporation A, which files its income tax returns on the calendar year basis, received in 1954 $100,000 as dividends on the preferred stock of Corporation B, a public utility corporation which is subject to taxation under chapter 1 of the Code. The deduction provided in section 247 is allowable to Corporation B, the distributing corporation, with respect to these dividends. The corporation normal tax rate and the surtax rate for the calendar year 1954 are 30 percent and 22 percent, respectively. The deduction allowable to Corporation A under section 244 for the year 1954 with respect to these dividends is $62,115.38, computed as follows:

Dividends received on preferred stock of Corporation B	$100,000.00
Less: The fraction specified in section 244 (2) $^{14}/_{52} \times \$100,000$	26,923.08
Amount subject to 85 percent deduction	73,076.92
Deduction: 85 percent of $73,076.92	62,115.38

Example (2). Assume the facts are the same as in example (1) except that the year involved is a taxable year for which the corporation normal tax rate and the surtax rate are 25 percent and 22 percent, respectively. The deduction allowable to Corporation A under section 244 for that taxable year is $59,680.85, computed as follows:

Dividends received on preferred stock of Corporation B	$100,000.00
Less: The fraction specified in section 244 (2) $^{14}/_{47} \times \$100,000$	29,787.23
Amount subject to 85 percent deduction	70,212.77
Deduction: 85 percent of $70,212.17	59,680.85

§ 1.245 Statutory provisions; dividends received from certain foreign corporations.

SEC. 245. *Dividends received from certain foreign corporations.* In the case of dividends received from a foreign corporation (other than a foreign personal holding company) which is subject to taxation under this chapter, if, for an uninterrupted period of not less than 36 months ending with the close of such foreign corporation's taxable year in which such dividends are paid (or, if the corporation has not been in existence for 36 months at the close of such taxable year, for the period the foreign corporation has been in existence as of the close of such taxable year) such foreign corporation has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States, there shall be allowed as a deduction in the case of a corporation—

(1) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of its earnings and profits specified in paragraph (2) of the first sentence of section 316 (a), but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such earnings and profits as the gross income of such foreign corporation for the taxable year from sources within the United States bears to its gross income from all sources for such taxable year, and

(2) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of that part of its earnings and profits specified in paragraph (1) of the first sentence of section 316 (a) accumulated after the beginning of such uninterrupted period, but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such accumulated earnings and profits as the gross income of such foreign corporation from sources within the United States for the portion of such uninterrupted period ending at the beginning of such taxable year bears to its gross income from all sources for such portion of such uninterrupted period.

§ 1.245–1 Deduction for dividends received from certain foreign corporations.

(a) A corporation is allowed a deduction under section 245 for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under chapter 1 of the Code if, for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid, such foreign corporation has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States. If the foreign corporation has been in existence less than 36 months as of the close of the taxable year in which the dividends are paid, then the applicable uninterrupted period to be taken into consideration in lieu of the uninterrupted period of 36 or more months is the entire period such corporation has been in existence as of the close of such taxable year. An uninterrupted period which satisfies the twofold requirement with respect to business activity and gross income may start at a date later than the date on which the foreign corporation first commenced an uninterrupted period of engaging in trade or business within the United States, but the applicable uninterrupted period is in any event the longest uninterrupted period which satisfies such twofold requirement.

(b) The deduction provided in section 245 for a taxable year, except as provided in section 246, is the sum of the amounts computed under paragraphs (1) and (2) of section 245.

(c) The determination of earnings and profits distributed in any taxable year shall be made in accordance with the principles of section 316 (a). For the determination of the source of income, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(d) The application of section 245 may be illustrated by the following examples:

Example (1). Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by Corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1943, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1954. Corporation A had accumulated earnings and profits of $50,000 immediately prior to January 1, 1943, and had earnings and profits of $10,000 for each taxable year during the uninterrupted period from January 1, 1943, through December 31, 1954. It derived for the period from January 1, 1943, through December 31, 1953, 90 percent of its gross income from sources within the United States and in 1954 derived 95 percent of its gross income from sources within the United States. During the calendar years 1943, 1944, 1945, 1946, and 1947 Corporation A distributed in each year $15,000; during the calendar years 1948, 1949, 1950, 1951, 1952, and 1953 it distributed in each year $5,000; and during the year 1954, $50,000. An analysis of the accumulated earnings and profits under the above statement of facts discloses that at December 31, 1953, the accumulation amounted to $55,000, of which $25,000 was accumulated prior to the "uninterrupted period" and $30,000 was accumulated during the uninterrupted period. (See section 316 (a) and paragraph (c) of this section.) For 1954 a deduction under section 245 of $31,025 ($8,075 on 1954 earnings of the foreign corporation, plus $22,950 from the $30,000 accumulation at December 31, 1953) for dividends received from a foreign corporation is allowable to Corporation B with respect to the $50,000 received from Corporation A, computed as follows:

(1) $8,075, which is $8,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of the $10,000 of earn-

ings and profits of the taxable year) multiplied by 95 percent (the portion of the gross income of Corporation A derived during the taxable year 1954 from sources within the United States), plus

(ii) $22,950, which is $26,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of $30,000, the part of the earnings and profits accumulated after the beginning of the uninterrupted period) multiplied by 90 percent (the portion of the gross income of Corporation A derived from sources within the United States during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example (2). If in example (1), Corporation A for the taxable year 1954 had incurred a deficit of $10,000 (shown to have been incurred before December 31) the amount of the earnings and profits accumulated after the beginning of the uninterrupted period would be $20,000. If Corporation A had distributed $50,000 on December 31, 1954, the deduction under section 245 for dividends received from a foreign corporation allowable to Corporation B for 1954 would be $15,300, computed by multiplying $17,000 (85 percent—the percent specified in section 243 for the calendar year 1954—of $20,000 earnings and profits accumulated after the beginning of the uninterrupted period) by 90 percent (the portion of the gross income of Corporation A derived from United States sources during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

§ 1.246 Statutory provisions; rules applying to deductions for dividends received.

SEC. 246. *Rules applying to deductions for dividends received*—(a) *Deduction not allowed for dividends from certain corporations.* The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

(1) A corporation organized under the China Trade Act, 1922 (see sec. 941); or

(2) A corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) A corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(b) *Limitation on aggregate amount of deductions*—(1) *General rule.* Except as provided in paragraph (2), the aggregate amount of the deductions allowed by sections 243(a), 244, and 245 shall not exceed 85 percent of the taxable income computed without regard to the deductions allowed by sections 172, 243(a), 244, 245, and 247.

(2) *Effect of net operating loss.* Paragraph (1) shall not apply for any taxable year for which there is a net operating loss (as determined under section 172).

(c) *Exclusion of certain dividends*—(1) *In general.* No deduction shall be allowed under section 243, 244, or 245, in respect of any dividend on any share of stock—

(A) Which is sold or otherwise disposed of in any case in which the taxpayer has held such share for 15 days or less, or

(B) To the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make corresponding payments with respect to substantially identical stock or securities.

(2) *90-day rule in the case of certain preference dividends.* In the case of any stock having preference in dividends, the holding period specified in paragraph (1)(A) shall be 90 days in lieu of 15 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days.

(3) *Determination of holding periods.* For purposes of this subsection, in determining the period for which the taxpayer has held any share of stock—

(A) The day of disposition, but not the day of acquisition, shall be taken into account,

(B) There shall not be taken into account any day which is more than 15 days (or 90 days in the case of stock to which paragraph (2) applies) after the date on which such share becomes ex-dividend, and

(C) Paragraph (4) of section 1223 shall not apply.

The holding periods determined under the preceding provisions of this paragraph shall be appropriately reduced (in the manner provided in regulations prescribed by the Secretary or his delegate) for any period (during such holding periods) in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities.

[Sec. 246(c) as added by sec. 18 and sec. 57 (c)(2), Technical Amendments Act 1958 (72 Stat. 1614, 1646)]

§ 1.246–1 Deductions not allowed for dividends from certain corporations.

The deductions provided in sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), are not allowable with respect to any dividend received from:

(a) A corporation organized under the China Trade Act, 1922 (15 U. S. C. ch. 4) (see section 941); or

(b) A corporation which is exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations) for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; or

(c) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year.

§ 1.246–2 Limitation on aggregate amount of deductions.

(a) *General rule.* The sum of the deductions allowed by sections 243(a) (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), except as provided in section 246(b)(2) and in paragraph (b) of this section, is limited to 85 percent of the taxable income of the corporation. The taxable income of the corporation for this purpose is computed without regard to the net operating loss deduction allowed by section 172, the deduction for dividends paid on certain preferred stock of public utilities allowed by section 247, and the deductions provided in sections 243(a), 244, and 245. For definition of the term "taxable income", see section 63.

(b) *Effect of net operating loss.* If the shareholder corporation has a net operating loss (as determined under section 172) for a taxable year, the limitation provided in section 246 (b) (1) and in paragraph (a) of this section is not applicable for such taxable year. In that event, the deductions provided in sections 243(a), 244, and 245 shall be allowable for all tax purposes to the shareholder corporation for such taxable year without regard to such limitation. If the shareholder corporation does not have a net operating loss for the taxable year, however, the limitation will be applicable for all tax purposes for such taxable year. In determining whether the shareholder corporation has a net operating loss for a taxable year under section 172, the deductions allowed by sections 243(a), 244, and 245 are to be computed without regard to the limitation provided in section 246(b)(1) and in paragraph (a) of this section.

§ 1.246–3 Exclusion of certain dividends.

(a) *In general.* Corporate taxpayers are denied, in certain cases, the dividends-received deduction provided by section 243 (dividends received by corporations), section 244 (dividends received on certain preferred stock), and section 245 (dividends received from certain foreign corporations). The above-mentioned dividends-received deductions are denied, under section 246(c)(1), to corporate shareholders:

(1) If the dividend is in respect of any share of stock which is sold or otherwise disposed of in any case where the taxpayer has held such share for 15 days or less; or

(2) If and to the extent that the taxpayer is under an obligation to make corresponding payments with respect to substantially identical stock or securities. It is immaterial whether the obligation has arisen pursuant to a short sale or otherwise.

(b) *Ninety-day rule for certain preference dividends.* In the case of any stock having a preference in dividends, a special rule is provided by section 246(c)(2) in lieu of the 15-day rule described in section 246(c)(1) and paragraph (a)(1) of this section. If the taxpayer receives dividends on such stock which are attributable to a period or periods aggregating in excess of 366 days, the holding period specified in section 246(c)(1)(A) shall be 90 days (in lieu of 15 days).

(c) *Definitions*—(1) *"Otherwise disposed of".* As used in this section the term "otherwise disposed of" includes disposal by gift.

(2) *"Substantially identical stock or securities".* The term "substantially identical stock or securities" is to be applied according to the facts and circumstances in each case. In general, the term has the same meaning as the corresponding terms in sections 1091 and 1233 and the regulations thereunder. See paragraph (d)(1) of § 1.1233–1.

(3) *Obligation to make corresponding payments.* (i) Section 246(c)(1)(B) of the Code denies the dividends-received deduction to a corporate taxpayer to the extent that such taxpayer is under an obligation, with respect to substantially identical stock or securities, to make payments corresponding to the dividend received. Thus, for example,

where a corporate taxpayer is in both a "long" and "short" position with respect to the same stock on the date that such stock goes ex-dividend, the dividend received on the stock owned by the taxpayer will not be eligible for the dividends-received deduction to the extent that the taxpayer is obligated to make payments to cover the dividends with respect to its offsetting short position in the same stock. The dividends-received deduction is denied in such a case without regard to the length of time the taxpayer has held the stock on which such dividends are received.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Y Corporation owns 100 shares of the Z Corporation's common stock on January 1, 1959. Z Corporation on January 15, 1959, declares a dividend of $1.00 per share payable to shareholders of record on January 30, 1959. On January 21, 1959, Y Corporation sells short 25 shares of the Z Corporation's common stock and remains in the short position on January 31, 1959, the day that Z Corporation's common stock goes ex-dividend. Y Corporation is therefore obligated to make a payment to the lender of the 25 shares of Z Corporation's common stock which were sold short, corresponding to the $1.00 a share dividend that the lender would have received on those 25 shares, or $25.00. Therefore, $25.00 of the $100.00 that the Y Corporation receives as dividends from the Z Corporation with respect to the 100 shares of common stock in which it has a long position is not eligible for the dividends-received deduction.

(d) *Determination of holding period*—(1) *In general.* Special rules are provided by paragraph (3) of section 246(c) for determining the period for which the taxpayer has held any share of stock for purposes of the restriction provided by such section. In computing the holding period the day of disposition but not the day of acquisition shall be taken into account. Also, there shall not be taken into account any day which is more than 15 days after the date on which the share of stock becomes ex-dividend. Thus, the holding period is automatically terminated at the end of such 15-day period without regard to how long the stock may be held after that date. In the case of stock qualifying under paragraph (2) of section 246(c) (as having preference in dividends) a 90-day period is substituted for the 15-day period prescribed in this subparagraph. Finally, section 1223(4), relating to holding periods in the case of wash sales, shall not apply. Therefore, tacking of the holding period of the stock disposed of to the holding period of the stock acquired where a wash sale occurs is not permitted for purposes of determining the holding period described in section 246(c).

(2) *Special rules.* Section 246 (c) requires that the holding periods determined thereunder shall be appropriately reduced for any period that the taxpayer's stock holding is offset by a corresponding short position resulting from an option to sell, a contractual obligation to sell, or a short sale of, substantially identical stock or securities. The holding periods of stock held for a period of 15 days or less on the date such short position is created shall accordingly be reduced to the extent of such short position. Where the amount of stock acquired within such period exceeds the amount as to which the taxpayer establishes a short position, the stock the holding period of which must be reduced because of such short position shall be that most recently acquired within such period. If, on the date the short position is created, the amount of stock subject to the short position exceeds the amount, if any, of stock held by the taxpayer for 15 days or less, the excess shares of stock sold short shall, to the extent thereof, postpone until the termination of the short position the commencement of the holding periods of subsequently acquired stock. Stock having a preference in dividends is also subject to the rules prescribed in this subparagraph, except that the 90-day period provided by paragraph (b) of this section shall apply in lieu of the 15-day period otherwise applicable. The rules prescribed in this subparagraph may be illustrated by the following examples:

Example (1). L Company purchased 100 shares of Z Corporation's common stock during January 1959. On November 26, 1959, L Company purchased an additional 100 shares of the same stock. On December 1, 1959, Z Corporation declared a dividend payable on its common stock to shareholders of record on December 20, 1959. Also on December 1, L Company sold short 150 shares of Z Corporation's common stock. On December 16, 1959 (before the stock went ex-dividend), L Company closed its short sale with 150 shares purchased on that date. In determining, for purposes of section 246(c), whether L Company has held the 100 shares of stock acquired on November 26 for a period in excess of 15 days, the period of the short position (from December 2 through December 16) shall be excluded. Thus, if on or before December 26, 1959, L Company sold the 100 shares of Z Corporation stock which it purchased on November 26, 1959, it would not be entitled to a dividends-received deduction for the dividends received on such shares because it would have held such shares for 15 days or less on the date of the sale. Since L Company had held the 100 shares acquired during January 1959 for more than 15 days on December 2, 1959, and since it was under no obligation to make payments corresponding to the dividends received thereon, section 246(c) is inapplicable to the dividends received with respect to those shares.

Example (2). Assume the same facts as in example (1) above except that the additional 100 shares of Z Corporation common stock were purchased by L Company on December 10, 1959, rather than November 26, 1959. In determining, for purposes of section 246(c), whether L Company has held such shares for a period in excess of 15 days, the period from December 11, 1959, until December 16, 1959 (the date the short sale made on December 1 was closed), shall be excluded.

(e) *Effective date.* The provisions of this section shall apply to stock acquired after December 31, 1957, or with respect to stock acquired before that date where the taxpayer has made a short sale of substantially identical stock or securities after that date.

§ 1.247 Statutory provisions; dividends paid on certain preferred stock of public utilities.

SEC. 247. *Dividends paid on certain preferred stock of public utilities*—(a) *Amount of deduction.* In the case of a public utility, there shall be allowed as a deduction an amount computed as follows:

(1) First determine the amount which is the lesser of—

(A) The amount of dividends paid during the taxable year on its preferred stock, or

(B) The taxable income for the taxable year (computed without the deduction allowed by this section).

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) The numerator of which is 14 percent, and

(B) The denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year specified in section 11.

For purposes of the deduction provided in this section, the amount of dividends paid shall not include any amount distributed in the current taxable year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. Amounts distributed in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year shall for purposes of this subsection be deemed to be distributed with respect to the earliest year or years for which there are dividends unpaid and accumulated.

(b) *Definitions.* For purposes of this section and section 244—

(1) *Public utility.* The term "public utility" means a corporation engaged in the furnishing of telephone service or in the sale of electrical energy, gas, or water, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof.

(2) *Preferred stock.* The term "preferred stock" means stock issued before October 1, 1942, which during the whole of the taxable year (or the part of the taxable year after its issue) was stock the dividends in respect of which were cumulative, limited to the same amount, and payable in preference to the payment of dividends on other stock. Stock issued on or after October 1, 1942, shall be deemed for purposes of this paragraph to have been issued before October 1, 1942, if it was issued (including issuance either by the same or another corporation in a transaction which is a reorganization (as defined in section 368 (a)), a transaction to which section 371 (relating to insolvency reorganizations) applies, or a transaction subject to part VI of subchapter O (relating to exchanges in SEC obedience orders), or the respectively corresponding provisions of the Internal Revenue Code of 1939) to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock (including stock which is preferred stock by reason of this sentence), but only to the extent that the par or stated value of the new stock does not exceed the par, stated, or face value of the bonds or debentures issued before October 1, 1942, or the other preferred stock, which such new stock is issued to refund or replace. The determination of whether stock was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, shall be made under regulations prescribed by the Secretary or his delegate.

§ 1.247–1 Deduction for dividends paid on preferred stock of public utilities.

(a) *Amount of deduction.* (1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on

certain preferred stock (see paragraph (c) of this section). This deduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is $\frac{14}{52}$. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will be $\frac{14}{47}$. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays $100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than $100,000 the deduction allowable to Corporation A under section 247 for 1954 is $100,000 times $\frac{14}{52}$, or $26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been $90,000 (that is, less than the amount of the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been $90,000 times $\frac{14}{52}$, or $24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247 (a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility states that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under section 247 to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(3) If a corporation which is engaged in one or more of the four types of business activities (called utility activities in this section) enumerated in section 247 (b) (1) (the furnishing of telephone service or the sale of electrical energy, gas, or water) is also engaged in some other business that does not fall within any of the enumerated categories, the deduction under section 247 is allowable only for such portion of the amount computed under section 247 (a) as is allocable to the income from utility activities. For this purpose, the allocation may be made on the basis of the ratio which the total income from the utility activities bears to total income from all sources (total income being considered either gross income or gross receipts, whichever method results in the higher deduction). However, if such an allocation reaches an inequitable result and the books of the corporation are so kept that the taxable income attributable to the utility activities can be readily determined, particularly where the books of the corporation are required by governmental bodies to be so kept for rate making or other purposes, the allocation may be made upon the basis of taxable income. No such apportionment will be required if the income from sources other than utility activities is less than 20 percent of the total income of the corporation, irrespective of the method used in determining such total income.

(b) *Public utility.* As used in section 247 and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The deduction provided in section 247 will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States, or from the operation of more than one such system and (2) that the regulation to which it is subject in part of its operating territory in one such system is effective to control rates within the unregulated territory of the same system so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock.* (1) For the purposes of section 247 and this section, preferred stock means stock (i) which was issued before October 1, 1942, (ii) the dividends in respect of which (during the whole of the taxable year, or the part of the taxable year after the actual date of the issue of such stock) were cumulative, nonparticipating as to current distributions, and payable in preference to the payment of dividends on other stock, and (iii) the rate of return on which is fixed and cannot be changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the deduction provided in section 247 shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of section 247 and this section whether the stock be voting or nonvoting stock.

(2) Preferred stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the deduction provided in section 247. If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247 (b) (2) (or the corresponding provision of the Internal Revenue Code of 1939), such new stock shall be considered as having been issued before October 1, 1942. If preferred stock is issued to refund or replace stock which was preferred stock within the

meaning of section 247 (b) (2) (or the corresponding provision of the Internal Revenue Code of 1939), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 247 (b) (2) (or the corresponding provision of the Internal Revenue Code of 1939), is not itself preferred stock within the meaning of section 247 (b) (2) (or the corresponding provision of the Internal Revenue Code of 1939), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the deduction provided in section 247.

(3) In the case of any preferred stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247 (b) (2) (or the corresponding provision of the Internal Revenue Code of 1939), only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the deduction allowable under section 247, but the appropriate allocable portion of the total amount of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 247 (b) (2) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of $100. On or after October 1, 1942, each of such bonds is retired in exchange for 1 1/10 shares of preferred stock issued on or after October 1, 1942, and having a par value of $100 per share. Only 10/11 of the dividends paid on the preferred stock thus issued in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if preferred stock which is issued on or after October 1, 1942, has no par value but a stated value of $50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not preferred stock issued on or after October 1, 1942, was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new preferred stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new preferred stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued before October 1, 1942, issues new preferred stock on October 1, 1954, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on November 1, 1954, such stock may be considered as having been issued to refund or replace bonds issued before October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Preferred stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued before October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued before October 1, 1942, if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939; or (ii) in a transaction to which section 371 (relating to insolvency reorganizations), or the corresponding provisions of the Internal Revenue Code of 1939, is applicable; or (iii) in a transaction which is subject to the provisions of part VI, subchapter O, chapter 1 of the Code (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission) or to the corresponding provisions of the Internal Revenue Code of 1939. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued before October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939, in a transaction to which section 371 or the corresponding provisions of the Internal Revenue Code of 1939 is applicable, or in a transaction which is subject to the provisions of part VI, subchapter O, chapter 1 of the Code, or to the corresponding provisions of the Internal Revenue Code of 1939. The provisions of this paragraph, in addition, are applicable in case a corporation issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued before October 1, 1942, by reason of having been issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 247 (b) (2), and no deduction will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 247 (b) (2) and in this paragraph.

§ 1.248 Statutory provisions; organizational expenditures.

SEC. 248. *Organizational expenditures*—(a) *Election to amortize.* The orgnizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary or his delegate), be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation (beginning with the month in which the corporation begins business).

(b) *Organizational expenditures defined.* The term "organizational expenditures" means any expenditure which—

(1) Is incident to the creation of the corporation;

(2) Is chargeable to capital account; and

(3) Is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

(c) *Time for and scope of election.* The election provided by subsection (a) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The period so elected shall be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years. The election shall apply only with respect to expenditures paid or incurred on or after the date of enactment of this title.

§ 1.248–1 Election to amortize organizational expenditures.

(a) *In general.* (1) Section 248(a) provides that a corporation may elect for any taxable year beginning after December 31, 1953, to treat its organizational expenditures, as defined in subsection (b) of section 248 and in paragraph (b) of this section, as deferred expenses. A corporation which

exercises such election must, at the time it makes the election, select a period of not less than 60 months, beginning with the month in which it began business, over which it will amortize its organizational expenditures. The period selected by the corporation may be equal to or greater, but not less, than 60 months, but in any event it must begin with the month in which the corporation began business. The organizational expenditures of the corporation which are treated as deferred expenses under the provisions of section 248 and this section shall then be allowed as a deduction in computing taxable income ratably over the period selected by the taxpayer. The period selected by the taxpayer in making its election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(2) If a corporation exercises the election provided in section 248 (a), such election shall apply to all of its expenditures which are organizational expenditures within the meaning of subsection (b) of section 248 and paragraph (b) of this section. The election shall apply, however, only with respect to expenditures incurred before the end of the taxable year in which the corporation begins business (without regard to whether the corporation files its returns on the accrual or cash method of accounting or whether the expenditures are paid in the taxable year in which they are incurred), if such expenditures are paid or incurred on or after August 16, 1954 (the date of enactment of the Internal Revenue Code of 1954).

(3) The deduction allowed under section 248 must be spread over a period beginning with the month in which the corporation begins business. The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

(b) *Organizational expenditures defined.* (1) Section 248 (b) defines the term "organizational expenditures." Such expenditures, for purposes of section 248 and this section, are those expenditures which are directly incident to the creation of the corporation. An expenditure, in order to qualify as an organizational expenditure, must be (i) incident to the creation of the corporation, (ii) chargeable to the capital account of the corporation, and (iii) of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. An expenditure which fails to meet each of these three tests may not be considered an organizational expenditure for purposes of section 248 and this section.

(2) The following are examples of organizational expenditures within the meaning of section 248 and this section: legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings, terms of original stock certificates, and the like; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to the State of incorporation.

(3) The following expenditures are not organizational expenditures within the meaning of section 248 and this section:

(i) Expenditures connected with issuing or selling shares or stock or other securities, such as commissions, professional fees, and printing costs. This is so even where the particular issue of stock to which the expenditures relate is for a fixed term of years;

(ii) Expenditures connected with the transfer of assets to a corporation.

(4) Expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation, are not organizational expenditures within the meaning of section 248 and this section.

(c) *Time and manner of making election.* The election provided by section 248 (a) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year in which it begins business. Such taxable year must be one which begins after December 31, 1953. The return and statement must be filed not later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the taxpayer begins business. The statement shall set forth the description and amount of the expenditures involved, the date such expenditures were incurred, the month in which the corporation began business, and the number of months (not less than 60 and beginning with the month in which the taxpayer began business) over which such expenditures are to be deducted ratably.

Items Not Deductible

§ 1.261 Statutory provisions; general rule for disallowance of deductions.

Sec. 261. *General rule for disallowance of deductions.* In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

§ 1.261–1 General rule for disallowance of deductions.

In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in chapter 1 of the Code, in respect of any of the items specified in part IX (section 262 and following), subchapter B, chapter 1 of the Code, and the regulations thereunder.

§ 1.262 Statutory provisions; personal, living, and family expenses.

Sec. 262. *Personal, living, and family expenses.* Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

§ 1.262–1 Personal, living, and family expenses.

(a) *In general.* In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in chapter 1 of the Code, for personal, living, and family expenses.

(b) *Examples of personal, living, and family expenses.* Personal, living, and family expenses are illustrated in the following examples:

(1) Premiums paid for life insurance by the insured are not deductible. See also section 264 and the regulations thereunder.

(2) The cost of insuring a dwelling owned and occupied by the taxpayer as a personal residence is not deductible.

(3) Expenses of maintaining a household, including amounts paid for rent, water, utilities, domestic service, and the like, are not deductible. A taxpayer who rents a property for residential purposes, but incidentally conducts business there (his place of business being elsewhere) shall not deduct any part of the rent. If, however, he uses part of the house as his place of business, such portion of the rent and other similar expenses as is properly attributable to such place of business is deductible as a business expense.

(4) Losses sustained by the taxpayer upon the sale or other disposition of property held for personal, living, and family purposes are not deductible. But see section 165 and the regulations thereunder for deduction of losses sustained to such property by reason of casualty, etc.

(5) Expenses incurred in traveling away from home (which include transportation expenses, meals, and lodging) and any other transportation expenses are not deductible unless they qualify as expenses deductible under section 162, § 1.162–2, and paragraph (d) of § 1.162–5 (relating to trade or business expenses), section 170 and paragraph (a) (2) of § 1.170–2 (relating to charitable contributions), section 212 and § 1.212–1 (relating to expenses for production of income), or section 213 (e) and paragraph (e) of § 1.213–1 (relating to medical expenses). The taxpayer's costs of commuting to his place of business or employment are personal expenses and do not qualify as deductible expenses. The costs of the taxpayer's lodging not incurred in traveling away from home are personal expenses. Except as permitted under section 162 or 212, the costs of the taxpayer's meals not incurred in traveling away from home are personal expenses.

(6) Amounts paid as damages for breach of promise to marry, and attorney's fees and other costs of suit to recover such damages, are not deductible.

(7) Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband

or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

(8) The cost of equipment of a member of the armed services is deductible only to the extent that it exceeds nontaxable allowances received for such equipment and to the extent that such equipment is especially required by his profession and does not merely take the place of articles required in civilian life. For example, the cost of a sword is an allowable deduction in computing taxable income, but the cost of a uniform is not. However, amounts expended by a reservist for the purchase and maintenance of uniforms which may be worn only when on active duty for training for temporary periods, when attending service school courses, or when attending training assemblies are deductible except to the extent that nontaxable allowances are received for such amounts.

(c) *Cross references.* Certain items of a personal, living, or family nature are deductible to the extent expressly provided under the following sections, and the regulations under those sections:

(1) Section 163 (interest).
(2) Section 164 (taxes).
(3) Section 165 (losses).
(4) Section 166 (bad debts).
(5) Section 170 (charitable, etc., contributions and gifts).
(6) Section 213 (medical, dental, etc., expenses).
(7) Section 214 (expenses for care of certain dependents).
(8) Section 215 (alimony, etc., payments).
(9) Section 216 (amounts representing taxes and interest paid to cooperative housing corporation).

§ 1.263(a) Statutory provisions; capital expenditures; general rule.

SEC. 263. *Capital expenditures*—(a) *General rule.* No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) Expenditures for the development of mines or deposits deductible under section 616,

(B) Research and experimental expenditures deductible under section 174, or

(C) Soil and water conservation expenditures deductible under section 175.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

§ 1.263(a)–1 Capital expenditures; in general.

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and § 1.162–4.

(c) The provisions of paragraph (a) (1) of this section shall not apply to expenditures deductible under—

(1) Section 616 and §§ 1.616–1 through 1.616–3, relating to the development of mines or deposits.

(2) Section 174 and §§ 1.174–1 through 1.174–4, relating to research and experimentation, and

(3) Section 175 and §§ 1.175–1 through 1.175–6, relating to soil and water conservation.

§ 1.263(a)–2 Examples of capital expenditures.

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments.

(c) The cost of defending or perfecting title to property.

(d) The amount expended for architect's services.

(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

(f) Amounts assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. Such amounts are capital investments and are not deductible. See section 118 and § 1.118–1.

(g) A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

§ 1.263(a)–3 Election to deduct or capitalize certain expenditures.

(a) Under certain provisions of the Code, taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) The sections referred to in paragraph (a) of this section include:

(1) Section 173 (circulation expenditures).
(2) Section 174 (research and experimental expenditures).
(3) Section 175 (soil and water conservation expenditures).
(4) Section 177 (trademark and trade name expenditures).
(5) Section 248 (organizational expenditures of a corporation).
(6) Section 266 (carrying charges).
(7) Section 615 (exploration expenditures).
(8) Section 616 (development expenditures).

§ 1.263(b) Statutory provisions; capital expenditures; expenditures for advertising and good will.

SEC. 263. *Capital expenditures.* * * *

(b) *Expenditures for advertising and good will.* If a corporation has, for the purpose of computing its excess profits tax credit under chapter 2E or subchapter D of chapter 1 of the Internal Revenue Code of 1939 claimed the benefits of the election provided in section 733 or section 451 of such code, as the case may be, no deduction shall be allowable under section 162 to such corporation for expenditures for advertising or the promotion of good will which, under the rules and regulations prescribed under section 733 or section 451 of such code, as the case may be, may be regarded as capital investments.

§ 1.263(b)–1 Expenditures for advertising or promotion of good will.

See § 1.162–14 for the rules applicable to a corporation which has elected to capitalize expenditures for advertising or the promotion of good will under the provisions of section 733 or section 451 of the Internal Revenue Code of 1939, in computing its excess profits tax credit under subchapter E, chapter 2, or subchapter D, chapter 1, of the Internal Revenue Code of 1939.

§ 1.263(c) Statutory provisions; capital expenditures; intangible drilling and development costs in the case of oil and gas wells.

SEC. 263. *Capital expenditures.* * * *

(c) *Intangible drilling and development costs in the case of oil and gas wells.* Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress.

§ 1.263(c)–1 Intangible drilling and development costs in the case of oil and gas wells.

For rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells, see § 1.612–4.

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§ 1.264 Statutory provisions; certain amounts paid in connection with insurance contracts.

SEC. 264. *Certain amounts paid in connection with insurance contracts*—(a) *General rule.* No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

(b) *Contracts treated as single premium contracts.* For purposes of subsection (a) (2), a contract shall be treated as a single premium contract—

(1) If substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) If an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§ 1.264–1 Premiums on life insurance taken out in a trade or business.

(a) *When premiums are not deductible.* Premiums paid by a taxpayer on a life insurance policy are not deductible from the taxpayer's gross income, even though they would otherwise be deductible as trade or business expenses, if they are paid on a life insurance policy covering the life of any officer or employee of the taxpayer, or any person (including the taxpayer) who is financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary of the policy. For additional provisions relating to the nondeductibility of premiums paid on life insurance policies (whether under section 162 or any other section of the Code), see section 262, relating to personal, living, and family expenses, and section 265, relating to expenses allocable to tax-exempt income.

(b) *When taxpayer is a beneficiary.* If a taxpayer takes out a policy for the purpose of protecting himself from loss in the event of the death of the insured, the taxpayer is considered a beneficiary directly or indirectly under the policy. However, if the taxpayer is not a beneficiary under the policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. See section 162 and the regulations thereunder. A taxpayer is considered a beneficiary under a policy where, for example, he, as a principal member of a partnership, takes out an insurance policy on his own life irrevocably designating his partner as the sole beneficiary in order to induce his partner to retain his investment in the partnership. Whether or not the taxpayer is a beneficiary under a policy, the proceeds of the policy paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, except in the case of (1) certain transferees, as provided in section 101 (a) (2); (2) portions of amounts of life insurance proceeds received at a date later than death under the provisions of section 101 (d); and (3) life insurance policy proceeds which are includible in the gross income of a husband or wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.). (See section 101 (e).) For further reference, see, generally, section 101 and the regulations thereunder.

§ 1.264–2 Single premium life insurance, endowment, or annuity contracts.

Amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium life insurance or endowment contract, or to purchase or to continue in effect a single premium annuity contract purchased (whether from the insurer, annuitant, or any other person) after March 1, 1954, are not deductible under section 163 or any other provision of chapter 1 of the Code. This prohibition applies even though the insurance is not on the life of the taxpayer and regardless of whether or not the taxpayer is the annuitant or payee of such annuity contract. A contract is considered a single premium life insurance, endowment, or annuity contract, for the purposes of this section, if substantially all the premiums on the contract are paid within four years from the date on which the contract was purchased, or if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§ 1.264–3 Effective date; taxable years ending after March 1, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.264–2, to the extent that they relate to amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single premium annuity contract purchased after March 1, 1954, and to the extent they consider a contract a single premium life insurance, endowment, or annuity contract if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract, shall also apply to taxable years beginning before January 1, 1954, and ending after March 1, 1954, and to taxable years beginning after December 31, 1953, and ending after March 1, 1954, but before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939.

§ 1.265 Statutory provisions; expenses and interest relating to tax-exempt income.

SEC. 265. *Expenses and interest relating to tax-exempt income.* No deduction shall be allowed for—

(1) *Expenses.* Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

(2) *Interest.* Interest on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from the taxes imposed by this subtitle.

§ 1.265–1 Expenses relating to tax-exempt income.

(a) *Nondeductibility of expenses allocable to exempt income.* (1) No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

(2) No amount shall be allowed as a deduction under section 212 (relating to expenses for production of income) for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt interest income.

(b) *Exempt income and nonexempt income.* (1) As used in this section, the term "class of exempt income" means any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Code. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is—

(i) Wholly excluded from gross income under any provision of subtitle A, or

(ii) Wholly exempt from the taxes imposed by subtitle A under the provisions of any other law.

(2) As used in this section the term "nonexempt income" means any income which is required to be included in gross income.

(c) *Allocation of expenses to a class or classes of exempt income.* Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(d) *Statement of classes of exempt income; records.* (1) A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (i) the amount of each class of exempt income, and (ii) the

amount of expenses and amounts otherwise allowable allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (c) of this section. If an item is apportioned between a class of exempt income and a class of nonexempt income, the statement shall show the basis of the apportionment. Such statement shall also recite that each deduction claimed in the return is not in any way attributable to a class of exempt income.

(2) The taxpayer shall keep such records as will enable him to make the allocations required by this section. See section 6001 and the regulations thereunder.

§ 1.265–2 Interest relating to tax-exempt income.

No amount shall be allowed as a deduction for interest on any indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from tax under subtitle A of the Code, such as municipal bonds, Panama Canal loan 3-percent bonds, or obligations of the United States, the interest on which is wholly exempt from tax under subtitle A, and which were issued after September 24, 1917, and not originally subscribed for by the taxpayer. Interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry (a) obligations of the United States issued after September 24, 1917, the interest on which is not wholly exempt from the taxes imposed under subtitle A of the Code, or (b) obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer, the interest on which is wholly exempt from the taxes imposed by subtitle A of the Code, is deductible. For rules as to the inclusion in gross income of interest on certain governmental obligations, see section 103 and the regulations thereunder.

§ 1.266 Statutory provisions; carrying charges.

SEC. 266. *Carrying charges.* No deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as, under regulations prescribed by the Secretary or his delegate, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes or charges as so chargeable.

§ 1.266–1 Taxes and carrying charges chargeable to capital account and treated as capital items.

(a) *In general.* In accordance with section 266, items enumerated in paragraph (b)(1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of subtitle A of the Code. No deduction is allowable for any items so treated.

(b) *Taxes and carrying charges.* (1) The taxpayer may elect, as provided in paragraph (c) of this section, to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are—

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive:

(*a*) Interest on a loan (but not theoretical interest of a taxpayer using his own funds),

(*b*) Taxes of the owner of such real property measured by compensation paid to his employees,

(*c*) Taxes of such owner imposed on the purchase of materials, or on the storage, use, or other consumption of materials, and

(*d*) Other necessary expenditures,

paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of income subject to tax (as in the case of a factory) or not (as in the case of a personal residence), or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein).

(iii) In the case of personal property:

(*a*) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein,

(*b*) Interest on a loan to purchase such property or to pay for transporting or installing the same, and

(*c*) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property,

paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

(iv) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(2) The sole effect of section 266 is to permit the items enumerated in subparagraph (1) of this paragraph to be chargeable to capital account notwithstanding that such items are otherwise expressly deductible under the provisions of subtitle A of the Code. An item not otherwise deductible may not be capitalized under section 266.

(3) In the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item to be construed as withdrawing or modifying the right now given to the taxpayer under any other provisions of subtitle A of the Code, or of the regulations thereunder, to elect to capitalize or to deduct a given item.

(c) *Election to charge taxes and carrying charges to capital account.* (1) If for any taxable year there are two or more items of the type described in paragraph (b) (1) of this section, which relate to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type. For purposes of this section, a "project" means, in the case of items described in paragraph (b) (1) (ii) of this section, a particular development of, or construction of an improvement to, real property, and in the case of items described in paragraph (b) (1) (iii) of this section, the transportation and installation of machinery or other fixed assets.

(2) (i) An election with respect to an item described in paragraph (b) (1) (i) of this section is effective only for the year for which it is made.

(ii) An election with respect to an item described in—

(*a*) Paragraph (b) (1) (ii) of this section is effective until the development or construction work described in that subdivision has been completed;

(*b*) Paragraph (b) (1) (iii) of this section is effective until the later of either the date of installation of the property described in that subdivision, or the date when such property is first put into use by the taxpayer;

(*c*) Paragraph (b) (1) (iv) of this section is effective as determined by the Commissioner.

Thus, an item chargeable to capital account under this section must continue to be capitalized for the entire period described in this subdivision applicable to such election although such period may consist of more than one taxable year.

(3) If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items (whether with

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respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account. Elections filed for taxable years beginning before January 1, 1954, and for taxable years ending before August 17, 1954, under section 24 (a) (7) of the Internal Revenue Code of 1939, and the regulations thereunder, shall have the same effect as if they were filed under this section. See section 7807 (b) (2).

(d) The following examples are illustrative of the application of the provisions of this section:

Example (1). In 1956 and 1957 A pays annual taxes and interest on a mortgage on a piece of real property. During 1956, the property is vacant and unproductive, but throughout 1957 A operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1956, but not the taxes and mortgage interest paid in 1957.

Example (2). In February 1957, B began the erection of an office building for himself. B in 1957, in connection with the erection of the building, paid $6,000 social security taxes, which in his 1957 return he elected to capitalize. B must continue to capitalize the social security taxes paid in connection with the erection of the building until its completion.

Example (3). Assume the same facts as in example (2) except that in November 1957, B also begins to build a hotel. In 1957 B pays $3,000 social security taxes in connection with the erection of the hotel. B's election to capitalize the social security taxes paid in erecting the office building started in February 1957 does not bind him to capitalize the social security taxes paid in erecting the hotel; he may deduct the $3,000 social security taxes paid in erecting the hotel.

Example (4). In 1957, M Corporation began the erection of a building for itself, which will take three years to complete. M Corporation in 1957 paid $4,000 social security taxes and $8,000 interest on a building loan in connection with this building. M Corporation may elect to capitalize the social security taxes although it deducts the interest charges.

Example (5). C purchases machinery in 1957 for use in his factory. He pays social security taxes on the labor for transportation and installation of the machinery, as well as interest on a loan to obtain funds to pay for the machinery and for transportation and installation costs. C may capitalize either the social security taxes or the interest, or both, up to the date of installation or until the machinery is first put into use by him, whichever date is later.

(e) *Allocation.* If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no election to treat as a capital item is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and circumstances in each case, shall be allocated to each item. The rule of this paragraph may be illustrated by the following example:

Example. N Corporation, the owner of a factory in New York on which a new addition is under construction, in 1957 pays its general manager, B, a salary of $10,000 and also pays a New York State unemployment insurance tax of $81 on B's salary. B spends nine-tenths of his time in the general business of the firm and the remaining one-tenth in supervising the construction work. N Corporation treats as expenses $9,000 of B's salary, and charges the remaining $1,000 to capital account. N Corporation may elect to capitalize $8.10 of the $81 New York State unemployment insurance tax paid in 1957 since such tax is deductible under section 164.

§ 1.267(a) Statutory provisions; losses, expenses, and interest with respect to transactions between related taxpayers; deductions disallowed.

SEC. 267. *Losses, expenses, and interest with respect to transactions between related taxpayers*—(a) *Deductions disallowed.* No deduction shall be allowed—

(1) *Losses.* In respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b).

(2) *Unpaid expenses and interest.* In respect of expenses, otherwise deductible under section 162 or 212, or of interest, otherwise deductible under section 163,—

(A) If within the period consisting of the taxable year of the taxpayer and 2½ months after the close thereof (i) such expenses or interest are not paid, and (ii) the amount thereof is not includible in the gross income of the person to whom the payment is to be made; and

(B) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

(C) If, at the close of the taxable year of the taxpayer or at any time within 2½ months thereafter, both the taxpayer and the person to whom the payment is to be made are persons specified within any one of the paragraphs of subsection (b).

§ 1.267(a)–1 Deductions disallowed.

(a) *Losses.* Except in cases of distributions in corporate liquidations, no deduction shall be allowed for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of the relationships specified in section 267 (b). See § 1.267 (b)–1.

(b) *Unpaid expenses and interest.* (1) No deduction shall be allowed a taxpayer for trade or business expenses otherwise deductible under section 162, for expenses for production of income otherwise deductible under section 212, or for interest otherwise deductible under section 163—

(i) If, at the close of the taxpayer's taxable year within which such items are accrued by the taxpayer or at any time within 2½ months thereafter, both the taxpayer and the payee are persons within any one of the relationships specified in section 267 (b) (see § 1.267 (b)–1); and

(ii) If the payee is on the cash receipts and disbursements method of accounting with respect to such items of gross income for his taxable year in which or with which the taxable year of accrual by the debtor-taxpayer ends; and

(iii) If, within the taxpayer's taxable year within which such items are accrued by the taxpayer and 2½ months after the close thereof, the amount of such items is not paid and the amount of such items is not otherwise (under the rules of constructive receipt) includible in the gross income of the payee.

(2) The provisions of section 267 (a) (2) and this paragraph do not otherwise affect the general rules governing the allowance of deductions under an accrual method of accounting. For example, if the accrued expenses or interest are paid after the deduction has become disallowed under section 267 (a) (2), no deduction would be allowable for the taxable year in which payment is made, since an accrual item is deductible only in the taxable year in which it is properly accruable.

(3) The expenses and interest specified in section 267 (a) (2) and this paragraph shall be considered as paid for purposes of that section to the extent of the fair market value on the date of issue of notes or other instruments of similar effect received in payment of such expenses or interest if such notes or other instruments were issued in such payment by the taxpayer within his taxable year or within 2½ months after the close thereof. The fair market value on the date of issue of such notes or other instruments of similar effect is includible in the gross income of the payee for the taxable year in which he receives the notes or other instruments.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. A, an individual, is the holder and owner of an interest-bearing note of the M Corporation, all the stock of which was owned by him on December 31, 1956. A and the M Corporation make their income tax returns for a calendar year. The M Corporation uses an accrual method of accounting. A uses a combination of accounting methods permitted under section 446 (c) (4) in which he uses the cash receipts and disbursements method in respect of items of gross income. The M Corporation does not pay any interest on the note to A during the calendar year 1956 or within 2½ months after the close of that year, nor does it credit any interest to A's account in such a manner that it is subject to his unqualified demand and thus is constructively received by him. M Corporation claims a deduction for the year 1956 for the interest accruing on the note in that year. Since A is on the cash receipts and disbursements method in respect of items of gross income, the interest is not includible in his return for the year 1956. Under the provisions of section 267 (a) (2) and this paragraph, no deduction for such interest is allowable in computing the taxable income of the M Corporation for the taxable year 1956 or for any other taxable year. However, if the interest had actually been paid to A on or before March 15, 1957, or if it had been made available to A before that time (and thus had been constructively received by him), the M Corporation would be allowed to deduct the amount of the payment in computing its taxable income for 1956.

(c) *Scope of section.* Section 267 (a) requires that deductions for losses or unpaid expenses or interest described therein be disallowed even though the transaction in which such losses, expenses, or interest were incurred was a bona fide transaction. However, section 267 is not exclusive. No deduction for losses or unpaid expenses or interest arising in a transaction which is not bona fide will be allowed even though section 267 does not apply to the transaction.

§ 1.267(b) Statutory provisions; losses, expenses, and interest with respect to transactions between related taxpayers; relationships.

SEC. 267. *Losses, expenses, and interest with respect to transactions between related taxpayers.* * * *

(b) *Relationships.* The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c) (4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations more than 50 percent in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; or

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.

§ 1.267(b)–1 Relationships.

(a) *In general.* (1) The persons referred to in section 267(a) and § 1.267 (a)–1 are specified in section 267(b).

(2) Under section 267 (b) (3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267 (b) (9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual's family, as defined in section 267 (c) (4) and paragraph (a) (4) of § 1.267 (c)–1, shall be taken into account.

(b) *Partnerships.* (1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and § 1.707–1. Any transaction described in section 267 (a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267 (b), no deductions with respect to such transactions between the other person and the partnership shall be allowed—

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2½ months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267 (a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705 (a) (2).

Example (2). Assume the same facts as in example (1) of this subparagraph except that the partnership and all the partners use the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2½ months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation's deduction for the accrued interest is not allowed to the extent of A's distributive share (one-third) of such interest income. M Corporation's deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A's one-third interest in the purchased property.

§ 1.267(c) Statutory provisions; losses, expenses, and interest with respect to transactions between related taxpayers; constructive ownership of stock.

SEC. 267. *Losses, expenses, and interest with respect to transactions between related taxpayers.* * * *

(c) *Constructive ownership of stock.* For purposes of determining, in applying subsection (b), the ownership of stock—

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

§ 1.267(c)–1 Constructive ownership of stock.

(a) *In genral.* (1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(2) For an individual to be considered under section 267 (c) (2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267 (c) (3) as owning the stock of a corporation owned either actually, or constructively under section 267 (c) (1), by or for his partner, such individual must himself actually own, or constructively own under section 267 (c) (1), stock of such corporation.

(3) An individual's constructive ownership, under section 267 (c) (2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's constructive ownership, under section 267 (c) (1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term "ancestors" includes parents and grandparents, and the term "lineal descendants" includes children and grandchildren.

(b) *Examples.* The application of section 267 (c) may be illustrated by the following examples:

Example (1). On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267 (c) (1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267 (c) (2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A's and AW's constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW's father, the constructive owner of the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW's constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family-ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW's constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

Person	Stock ownership in M Corporation		Total under Section 267	Stock ownership in O Corporation		Total under Section 267
	Actual	Constructive		Actual	Constructive	
	Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
A	75	25	100	None	60	80
					20	
AW (A's wife)	25	75	100	None	20	80
					60	
AWF (AW's father)	None	25	25	None	20	20
M Corporation	None	None	None	80	None	80
O Corporation						

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that either corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm's length sale or exchange between A and AWF, and between AWF and the M or O Corporation.

Example (2). On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1957, between A and the N Corporation or AP and the N Corporation since each partner is considered as owning the stock owned by the other; therefore, each is considered as owning more than 50 percent in value of the outstanding stock of the N Corporation.

Example (3). On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP, owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under section 267 (c) (1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by section 267 (a) (except for distributions in liquidation of X Corporation).

§ 1.267(d) Statutory provisions; losses, expenses, and interest with respect to transactions between related taxpayers; amount of gain where loss previously disallowed.

SEC. 267. *Losses, expenses, and interest with respect to transactions between related taxpayers.* * * *

(d) *Amount of gain where loss previously disallowed.* If—

(1) In the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a) (1) (or by reason of section 24 (b) of the Internal Revenue Code of 1939); and

(2) After December 31, 1953, the taxpayer sells or otherwise disposes of such property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain,

then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer. This subsection applies with respect to taxable years ending after December 31, 1953. This subsection shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091 (relating to wash sales) or by reason of section 118 of the Internal Revenue Code of 1939.

§ 1.267(d)–1 Amount of gain where loss previously disallowed.

(a) *General rule.* (1) If a taxpayer acquires property by purchase or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939), then any gain realized by the taxpayer on a sale or other disposition of the property after December 31, 1953, shall be recognized only to the extent that the gain exceeds the amount of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

(2) The general rule is also applicable to a sale or other disposition of property by a taxpayer when the basis of such property in the taxpayer's hands is determined directly or indirectly by reference to other property acquired by the taxpayer from a transferor through a sale or exchange in which a loss sustained by the transferor was not allowable. Therefore, section 267 (d) applies to a sale or other disposition of property after a series of transactions if the basis of the property acquired in each transaction is determined by reference to the basis of the property transferred, and if the original property was acquired in a transaction in which a loss to a transferor was not allowable by reason of section 267 (a) (1) (or by reason of section 24 (b) of the Internal Revenue Code of 1939).

(3) The benefit of the general rule is available only to the original transferee but does not apply to any original transferee (e. g., a donee) who acquired the property in any manner other than by purchase or exchange.

(4) The application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). H sells to his wife, W, for $500, certain corporate stock with an adjusted basis for determining loss to him of $800. The loss of $300 is not allowable to H by reason of section 267 (a) (1) and paragraph (a) of § 1.267 (a)–1. W later sells this stock for $1,000. Although W's realized gain is $500 ($1,000 minus $500, her basis), her recognized gain under section 267 (d) is only $200, the excess of the realized gain of $500 over the loss of $300 not allowable to H. In determining capital gain or loss W's holding period commences on the date of the sale from H to W.

Example (2). Assume the same facts as in example (1) except that W later sells her stock for $300 instead of $1,000. Her recognized loss is $200 and not $500 since section 267 (d) applies only to the nonrecognition of gain and does not affect basis.

Example (3). Assume the same facts as in example (1) except that W transfers her stock as a gift to X. The basis of the stock in the hands of X for the purpose of determining gain, under the provisions of section 1015, is the same as W's, or $500. If X later sells the stock for $1,000 the entire $500 gain is taxed to him.

Example (4). H sells to his wife, W, for $5,500, farmland, with an adjusted basis for determining loss to him of $8,000. The loss of $2,500 is not allowable to H by reason of section 267 (a) (1) and paragraph (a) of § 1.267 (a)–1. W exchanges the farmland, held for investment purposes, with S, an unrelated individual, for two city lots, also held for investment purposes. The basis of the

city lots in the hands of W ($5,500) is a substituted basis determined under section 1031 (d) by reference to the basis of the farmland. Later W sells the city lots for $10,000. Although W's realized gain is $4,500 (10,000 minus $5,500), her recognized gain under section 267 (d) is only $2,000, the excess of the realized gain of $4,500 over the loss of $2,500 not allowable to H.

(b) *Determination of basis and gain with respect to divisible property*—(1) *Taxpayer's basis.* When the taxpayer acquires divisible property or property that consists of several items or classes of items by a purchase or exchange on which loss is not allowable to the transferor, the basis in the taxpayer's hands of a particular part, item, or class of such property shall be determined (if the taxpayer's basis for that part is not known) by allocating to the particular part, item, or class a portion of the taxpayer's basis for the entire property in the proportion that the fair market value of the particular part, item, or class bears to the fair market value of the entire property at the time of the taxpayer's acquisition of the property.

(2) *Taxpayer's recognized gain.* Gain realized by the taxpayer on sales or other dispositions after December 31, 1953, of a part, item, or class of the property shall be recognized only to the extent that such gain exceeds the amount of loss attributable to such part, item, or class of property not allowable to the taxpayer's transferor on the latter's sale or exchange of such property to the taxpayer.

(3) *Transferor's loss not allowable.* (i) The transferor's loss on the sale or exchange of a part, item, or class of the property to the taxpayer shall be the excess of the transferor's adjusted basis for determining loss on the part, item, or class of the property over the amount realized by the transferor on the sale or exchange of the part, item, or class. The amount realized by the transferor on the part, item, or class shall be determined (if such amount is not known) in the same manner that the taxpayer's basis for such part, item, or class is determined. See subparagraph (1) of this paragraph.

(ii) If the transferor's basis for determining loss on the part, item, or class cannot be determined, the transferor's loss on the particular part, item, or class transferred to the taxpayer shall be determined by allocating to the part, item, or class a portion of his loss on the entire property in the proportion that the fair market value of such part, item, or class bears to the fair market value of the entire property on the date of the taxpayer's acquisition of the entire property.

(4) *Examples.* The application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). During 1953, H sold class A stock, which had cost him $1,100, and common stock which had cost him $2,000, to his wife W for a lump sum of $1,500. Under section 24 (b) (1) (A) of the 1939 Code, the loss of $1,600 on the transaction was not allowable to H. At the time the stocks were purchased by W, the fair market value of class A stock was $900 and the fair market value of common stock was $600. In 1954, W sold the class A stock for $2,500. W's recognized gain is determined as follows:

Amount realized by W on sale of class A stock		$2,500
Less: Basis allocated to class A stock—$900/$1,500 x $1,500		900
Realized gain on transaction		1,600
Less: Loss sustained by H on sale of class A stock to W not allowable as a deduction:		
Basis to H of class A stock	$1,100	
Amount realized by H on class A stock—$900/$1,500 x $1,500	900	
Unallowable loss to H on sale of class A stock		200
Recognized gain on sale of class A stock by W		1,400

Example (2). Assume the same facts as those stated in example (1) of this subparagraph except that H originally purchased both classes of stock for a lump sum of $3,100. The unallowable loss to H on the sale of all the stock to W is $1,600 ($3,100 minus $1,500). An exact determination of the unallowable loss sustained by H on sale to W of class A stock cannot be made because H's basis for class A stock cannot be determined. Therefore, a determination of the unallowable loss is made by allocating to class A stock a portion of H's loss on the entire property transferred to W in the proportion that the fair market value of class A stock at the time acquired by W ($900) bears to the fair market value of both classes of stock at that time ($1,500). The allocated portion is $900/$1,500 x $1,600, or $960. W's recognized gain is, therefore, $640 (W's realized gain of $1,600 minus $960).

(c) *Special rules.* (1) Section 267 (d) does not affect the basis of property for determining gain. Depreciation and other items which depend on such basis are also not affected.

(2) The provisions of section 267 (d) shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091, or section 118 of the Internal Revenue Code of 1939, which relate to losses from wash sales of stock or securities.

(3) In determining the holding period in the hands of the transferee of property received in an exchange with a transferor with respect to whom a loss on the exchange is not allowable by reason of section 267, section 1223 (2) does not apply to include the period during which the property was held by the transferor. In determining such holding period, however, section 1223 (1) may apply to include the period during which the transferee held the property which he exchanged where, for example, he exchanged a capital asset in a transaction which, as to him, was nontaxable under section 1031 and the property received in the exchange has the same basis as the property exchanged.

§ 1.267(d)–2 Effective date; taxable years subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.267(d)–1, to the extent that they relate to determination of gain resulting from the sale or other disposition of property after December 31, 1953, with respect to which property a loss was not allowable to the transferor by reason of section 267(a)(1) (or by reason of section 24 (b) of the Internal Revenue Code of 1939), shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and taxable years beginning after December 31, 1953, and ending before August 17, 1954, which years are subject to the Internal Revenue Code of 1939.

§ 1.268 Statutory provisions; sale of land with unharvested crop.

SEC. 268. *Sale of land with unharvested crop.* Where an unharvested crop sold by the taxpayer is considered under the provisions of section 1231 as "property used in the trade or business", in computing taxable income no deduction (whether or not for the taxable year of the sale and whether for expenses, depreciation, or otherwise) attributable to the production of such crop shall be allowed.

§ 1.268–1 Items attributable to an unharvested crop sold with the land.

In computing taxable income no deduction shall be allowed in respect of items attributable to the production of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231 (b) (4). Such items shall be so treated whether or not the taxable year involved is that of the sale, exchange, or conversion of such crop and whether they are for expenses, depreciation, or otherwise. If the taxable year involved is not that of the sale, exchange, or conversion of such crop, a recomputation of the tax liability for such year shall be made; such recomputation should be in the form of an "amended return" if necessary. For the adjustments to basis as a result of such disallowance, see section 1016 (a) (11) and the regulations thereunder.

§ 1.269 [Reserved]

§ 1.270 Statutory provisions; limitation on deductions allowable to individuals in certain cases.

SEC. 270. *Limitation on deductions allowable to individuals in certain cases*—(a) *Recomputation of taxable income.* If the deductions allowed by this chapter or the corresponding provisions of prior revenue laws (other than specially treated deductions, as defined in subsection (b)) allowable to an individual (except for the provisions of this section or the corresponding provisions of prior revenue laws) and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years (including at least one year to which this subtitle applies), exceeded by more than $50,000 the gross income derived from such trade or business, the taxable income (computed under section 63 or the corresponding provisions of prior revenue laws) of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

(b) *Specially treated deductions.* For the purpose of subsection (a) the specially treated deductions shall be taxes, interest, casualty and abandonment losses connected with a trade or business deductible under section 165 (c) (1), losses and expenses of the trade or business of farming which are

directly attributable to drought, the net operating loss deduction allowed by section 172, and expenditures as to which taxpayers are given the option, under law or regulations, either (1) to deduct as expenses when incurred or (2) to defer or capitalize.

(c) *Redetermination of tax.* On the basis of the taxable income computed under the provisions of subsection (a) for each of the 5 consecutive taxable years specified in such subsection, the tax imposed by this subtitle or the corresponding provisions of prior revenue laws shall be redetermined for each such taxable year. If for any such taxable year assessment of a deficiency is prevented (except for the provisions of section 1311 and following) by the operation of any law or rule of law (other than section 7122, relating to compromises), any increase in the tax previously determined for such taxable year shall be considered a deficiency for purposes of this section. For purposes of this section, the term "tax previously determined" shall have the meaning assigned to such term by section 1314 (a) (1).

(d) *Extension of statute of limitations.* Notwithstanding any law or rule of law (other than section 7122, relating to compromises), any amount determined as a deficiency under subsection (c), or which would be so determined if assessment were prevented in the manner described in subsection (c), with respect to any taxable year may be assessed as if on the date of the expiration of the time prescribed by law for the assessment of a deficiency for the fifth taxable year of the 5 consecutive taxable years specified in subsection (a), 1 year remained before the expiration of the period of limitation upon assessment for any such taxable year.

§ 1.270–1 Limitation on deductions allowable to individuals in certain cases.

(a) *Recomputation of taxable income.* (1) Under certain circumstances, section 270 limits the deductions (other than certain deductions described in subsection (b) thereof) attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1 of the Code or the corresponding provisions of prior revenue laws. If, in each of five consecutive taxable years (including at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954), the deductions attributable to a trade or business carried on by an individual (other than the specially treated deductions described in paragraph (b) of this section) exceed the gross income derived from such trade or business by more than $50,000, the taxable income computed under section 63 (or the net income computed under the corresponding provisions of prior revenue laws) of such individual shall be recomputed for each of such taxable years.

(2) In recomputing the taxable income (or the net income, in the case of taxable years which are otherwise subject to the Internal Revenue Code of 1939) for each of the five taxable years, the deductions (other than the specially treated deductions described in paragraph (b) of this section with the exception of the net operating loss deduction) attributable to the trade or business carried on by the individual shall be allowed only to the extent of (i) the gross income derived from such trade or business, plus (ii) $50,000. The specially treated deductions described in paragraph (b) of this section (other than the net operating loss deduction) shall each be allowed in full. The net operating loss deduction, to the extent attributable to such trade or business, shall be disallowed in its entirety. Thus, a carryover or a carryback of a net operating loss so attributable, either from a year within the period of five consecutive taxable years or from a taxable year outside of such period, shall be ignored in making the recomputation of taxable income or net income, as the case may be.

(3) The limitations on deductions provided by section 270 are also applicable in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover or carryback from any year which falls within the provisions of section 270 to any year which does not fall within such provisions. Also, in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover from a year which falls within the provisions of section 270 to a year which does not fall within such provisions, the amount of net operating loss is to be reduced by the taxable income or net income, as the case may be (computed as provided in § 1.172–5, or 26 CFR (1939) 39.122–4(c) (Regulations 118), as the case may be and, in the case of any taxable year which falls within the provisions of section 270, determined after the application of section 270), of any taxable year preceding or succeeding the taxable year of the net operating loss to which such loss must first be carried back or carried over under the provisions of section 172 (b), or the corresponding provisions of prior revenue laws, even though the net operating loss deduction is not an allowable deduction for such preceding or succeeding taxable year.

(4) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses and the gross income derived therefrom shall not be aggregated in determining whether the deductions (other than the specially treated deductions) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. For the purposes of section 270, each trade or business shall be considered separately. However, where a particular business of an individual is conducted in one or more forms such as a partnership, joint venture, or individual proprietorship, the individual's share of the profits and losses from each business unit must be aggregated to determine the applicability of section 270. See paragraphs (a) (8) (ii) and (b) of § 1.702–1, relating to applicability of section 270 to a partner. Where it is established that for tax purposes a husband and wife are partners in the same trade or business or that each is participating independently of the other in the same trade or business with his and her own money, the husband's gross income and deductions from that trade or business shall be considered separately from the wife's gross income and deductions from that trade or business even though they file a joint return. Where a taxpayer is engaged in a trade or business in a community property State under circumstances such that the income therefrom is considered to be community income, the taxpayer and his spouse are treated for purposes of section 270 as two individuals engaged separately in the same trade or business and the gross income and deductions attributable to the trade or business are allocated one-half to the taxpayer and one-half to the spouse. Where several business activities emanate from a single commodity, such as oil or gas or a tract of land, it does not necessarily follow that such activities are one business for the purposes of section 270. However, in order to be treated separately, it must be established that such business activities are actually conducted separately and are not closely interrelated with each other. For the purposes of section 270, the trade or business carried on by an individual must be the same in each of the five consecutive years in which the deductions (other than the specially treated deductions) exceed the gross income derived from such trade or business by more than $50,000.

(5) For the purposes of section 270, a taxable year may be part of two or more periods of five consecutive taxable years. Thus, if the deductions (other than the specially treated deductions) attributable to a trade or business carried on by an individual exceed the gross income therefrom by more than $50,000 for each of six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a five-year period beginning with the first and ending with the fifth taxable year and of a five-year period beginning with the second and ending with the sixth taxable year.

(6) For the purposes of section 270, a short taxable year required to effect a change in accounting period constitutes a taxable year. In determining the applicability of section 270 in the case of a short taxable year, items of income and deduction are not annualized.

(b) *Specially treated deductions.* (1) For the purposes of section 270 and paragraph (a) of this section, the specially treated deductions are:

(i) Taxes,

(ii) Interest,

(iii) Casualty and abandonment losses connected with a trade or business deductible under section 165 (c) (1), or the corresponding provisions of prior revenue laws,

(iv) Losses and expenses of the trade or business of farming which are directly attributable to drought,

(v) The net operating loss deduction allowed by section 172, or the corresponding provisions of prior revenue laws, and

(vi) Expenditures as to which a taxpayer is given the option, under law or regulations, either (*a*) to deduct as expenses when incurred, or (*b*) to defer or capitalize.

(2) For the purpose of subparagraph (1) (iv) of this paragraph, an individual is engaged in the "trade or business of farming" if he cultivates, operates, or manages a farm for gain or profit, either

as owner or tenant. An individual who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the trade or business of farming. However, an individual who receives a fixed rental (without reference to production) is engaged in the trade or business of farming only if he participates to a material extent in the operation or management of the farm. An individual engaged in forestry or the growing of timber is not thereby engaged in the trade or business of farming. An individual cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the trade or business of farming. The term "farm" is used in its ordinarily accepted sense and includes stock, dairy, poultry, fruit, crop, and truck farms, and also plantations, ranches, ranges, and orchards. An individual is engaged in the trade or business of farming if he is a member of a partnership engaged in the trade or business of farming.

(3) In order for losses and expenses of the trade or business of farming to qualify as specially treated deductions under subparagraph (1) (iv) of this paragraph such losses and expenses must be directly attributable to drought conditions and not to other causes such as faulty management or unfavorable market conditions. In general, the following are the types of losses and expenses which, if otherwise deductible, may qualify as specially treated deductions under subparagraph (1) (iv) of of this paragraph:

(i) Losses for damages to or destruction of property as a result of drought conditions, if such property is used in the trade or business of farming or is purchased for resale in the trade or business of farming;

(ii) Expenses directly related to raising crops or livestock which are destroyed or damaged by drought. Included in this category are, for example, payments for labor, fertilizer, and feed used in raising such crops or livestock. If such crops or livestock to which the expenditures relate are only partially destroyed or damaged by drought then only a proportionate part of the expenditures is regarded as specially treated deductions; and

(iii) Expenses which would not have been incurred in the absence of drought conditions, such as expenses for procuring pasture or additional supplies of water or feed.

(4) The expenditures referred to in subparagraph (1) (vi) of this paragraph include, but are not limited to, intangible drilling and development costs in the case of oil and gas wells as provided in section 263 (c) and the regulations thereunder, and expenditures for the development of a mine or other natural deposit (other than an oil or gas well) as provided in section 616 and the regulations thereunder.

(5) The provisions of section 270 (b) do not operate to make an expenditure a deductible item if it is not otherwise deductible under the law applicable to the particular year in which it was incurred. Thus, for example, if it is necessary, pursuant to the provisions of section 270, to recompute the taxable or net income of an individual for the taxable years 1950 through 1954, the individual in making the recomputation may not deduct expenditures paid or incurred in the years 1950 through 1953 which must be capitalized under the law applicable to those years, even though the expenditures are deductible under the Code.

(c) *Applicability to taxable years otherwise subject to the Internal Revenue Code of 1939.* The net income of a taxable year otherwise subject to the Internal Revenue Code of 1939 shall be recomputed pursuant to section 270 if (i) such taxable year is included in a period of five consecutive taxable years which includes at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954, and (ii) the deductions (other than the specially treated deductions specified in section 270 (b)) for each taxable year in such five-year period exceed the $50,000 limitation specified in section 270. As described in paragraph (a) (5) of this section, a taxable year may be part of two or more periods of five consecutive taxable years. If a particular taxable year is part of two periods of five consecutive taxable years, one meeting the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939 and the other meeting the requirements for recomputation pursuant to section 270 of the Internal Revenue Code of 1954, then the recomputation for such taxable year shall be made pursuant to section 270. For example, if a calendar year taxpayer sustains a loss from a trade or business for each of the years 1949 through 1954, the years 1950, 1951, 1952, and 1953 may be a part of two such periods of five consecutive taxable years. If, however, a taxable year is part of a period of five consecutive taxable years which meets the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939, but is not part of a period which meets the requirements for recomputation pursuant to section 270, then a recomputation of net income for such taxable year must be made pursuant to section 130.

(d) *Redetermination of tax.* The tax imposed by chapter 1 of the Code, or by the corresponding provisions of prior revenue laws, for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the taxable income or net income of the individual, as the case may be, recomputed in the manner described in paragraph (a) of this section. If the assessment of a deficiency is prevented (except for the provisions of part II (section 1311 and following), subchapter Q, chapter 1 of the Code, relating to the effect of limitations and other provisions in income tax cases) by the operation of any provision of law (e.g., sections 6501 and 6502, or the corresponding provisions of prior revenue laws, relating to the period of limitations upon assessment and collection) except section 7122, or the corresponding provisions of prior revenue laws, relating to compromises, or by any rule of law (e. g., res judicata), then the excess of the tax for such year as recomputed over the tax previously determined for such year shall be considered a deficiency for the purposes of section 270. The term "tax previously determined" shall have the same meaning as that assigned to such term by section 1314 (a). See § 1.1314 (a)–1.

(e) *Assessment of tax.* Any amount determined as a deficiency in the manner described in paragraph (d) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 270, the amount of the actual deficiency as defined in section 6211 (a) (whether it is greater than, equal to, or less than the deficiency determined under section 270 (c)) shall be assessed and collected. However, if the assessment of a deficiency for such taxable year would be prevented by any provision of law (e. g., the period of limitation upon the assessment of tax) except section 7122, or the corresponding provision of prior revenue laws, relating to compromises, or by the operation of any rule of law (e. g., res judicata), then the excess of the tax recomputed as described in paragraph (d) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 6211 (a), in respect of the given taxable year.

§ 1.271 Statutory provisions; debts owed by political parties, etc.

SEC. 271. *Debts owed by political parties, etc.*—(a) *General rule.* In the case of a taxpayer (other than a bank as defined in section 581) no deduction shall be allowed under section 166 (relating to bad debts) or under section 165 (g) (relating to worthlessness of securities) by reason of the worthlessness of any debt owed by a political party.

(b) *Definitions*—(1) *Political party.* For purposes of subsection (a), the term "political party" means—

(A) A political party;

(B) A national, State, or local committee of a political party; or

(C) A committee, association, or organization which accepts contributions or makes expenditures for the purpose of influencing or attempting to influence the election of presidential or vice-presidential electors or of any individual whose name is presented for election to any Federal, State, or local elective public office, whether or not such individual is elected.

(2) *Contributions.* For purposes of paragraph (1) (C), the term "contributions" includes a gift, subscription, loan, advance, or deposit, of money, or anything of value, and includes a contract, promise, or agreement to make a contribution, whether or not legally enforceable.

(3) *Expenditures.* For purposes of paragraph (1) (C), the term "expenditures" includes a payment, distribution, loan, advance, deposit, or gift, of money, or anything of value, and includes a contract,

promise, or agreement to make an expenditure, whether or not legally enforceable.

§ 1.272 Statutory provisions; disposal of coal.

SEC. 272. *Disposal of coal.* Where the disposal of coal is covered by section 631, no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that if in any taxable year such expenditures plus the adjusted depletion basis of the coal disposed of in such taxable year exceed the amount realized under such contract, such excess, to the extent not availed of as a reduction of gain under section 1231, shall be a loss deductible under section 165 (a). This section shall not apply to any taxable year during which there is no income under the contract.

§ 1.272–1 Expenditures relating to disposal of coal.

(a) *Introduction.* Section 272 provides special treatment for certain expenditures paid or incurred by a taxpayer in connection with a contract (hereafter sometimes referred to as a "coal royalty contract") for the disposal of coal the gain or loss from which is treated under section 631(c) as a section 1231 gain or loss on the sale of coal. The expenditures covered by section 272 are those which are attributable to the making and administering of such a contract or to the preservation of the economic interest retained under the contract. For examples of such expenditures, see paragraph (d) of this section. For a taxable year in which gross royalty income is realized under the contract of disposal, such expenditures shall not be allowed as a deduction. Instead, they are to be added to the adjusted depletion basis of the coal disposed of in such taxable year in computing gain or loss under section 631 (c). However, where no gross royalty income is realized under the contract of disposal in a particular taxable year, such expenditures shall be treated without regard to section 272.

(b) *In general.* (1) Where the disposal of coal is covered by section 631 (c), the provisions of section 272 and this section shall be applicable for a taxable year in which there is income under the contract of disposal. (For purposes of section 272 and this section, the term "income" means gross amounts received or accrued which are royalties or bonuses in connection with a contract to which section 631 (c) applies.) All expenditures paid or incurred by the taxpayer during such taxable year which are attributable to the making and administering of the contract disposing of the coal and all expenditures paid or incurred during such taxable year in order to preserve the owner's economic interest retained under the contract shall be disallowed as deductions in computing taxable income for such taxable year. The sum of such expenditures and the adjusted depletion basis of the coal disposed of in such taxable year shall be used in determining the amount of gain or loss with respect to the disposal. See § 1.631–3. For special rule in case of loss, see paragraph (c) of this section. Section 272 and this section are not applicable to capital expenditures and such expenditures are not taken into account in computing gain or loss under section 631 (c) except to the extent they are properly part of the depletable basis of such coal.

(2) The expenditures covered under section 272 and this section are disallowed as a deduction only with respect to a taxable year in which income is realized under the coal royalty contract to which such expenditures are attributable. Where no income is realized under such contract in a taxable year, these expenditures shall be deducted as expenses for the production of income, as a business expense, or may be treated under section 266 (relating to taxes and carrying charges) if applicable.

(3) The provisions of section 272 and this section apply to a taxable year in which income from the disposal by the owner of coal held by him for more than six months is subject to the provisions of section 631 (c) even though the actual mining of coal under the coal royalty contract does not take place during such year. Where the right under the contract to mine coal for which advance payment has been made expires, terminates, or is abandoned before such coal is mined, and paragraph (c) of § 1.631–3 requires the owner to recompute his tax with respect to such payment the recomputation must be made without applying the provisions of section 272 and this section.

(c) *Losses.* If, in any taxable year, the expenditures referred to in section 272 and this section plus the adjusted depletion basis (as defined in paragraph (b) (2) of § 1.631–3) of the coal disposed of during the taxable year exceed the amount realized under the contract which is subject to section 631 (c) during the taxable year, such excess shall be considered under section 1231 as a loss from the sale of property used in the trade or business and, to the extent not availed of as a reduction of gain under that section, shall be a loss deductible under section 165 (a) (relating to the deduction of losses generally).

(d) *Examples of expenditures.* (1) The expenditures referred to in section 272 include, but are not limited to, the following items, if such items are attributable to the making or administering of the contract or preserving the economic interest therein: Ad valorem taxes imposed by State or local authorities, costs of fire protection, costs of insurance (other than liability insurance), costs incurred in administering the contract (including costs of bookkeeping and technical supervision), interest on loans, expenses of flood control, legal and technical expenses, and expenses of measuring and checking quantities of coal disposed of under the contract. Whether the interest on loans is attributable to the making or administering of the contract or preserving the economic interest therein will depend upon the use to which the borrowed monies are put.

(2) Any expenditure referred to in this section which is applicable to more than one coal royalty contract shall be reasonably apportioned to each such contract. Furthermore, if an expenditure applies only in part to the making or administering of the contract or the preservation of the economic interest, then only such part shall be treated under section 272. The apportionment of the expenditure shall be made on a reasonable basis. For example, where a taxpayer has other income (such as income from oil or gas royalties, rentals, right of way fees, interest, or dividends) as well as income under section 631 (c), and where the salaries of some of its employees or other expenses relate to both classes of income, such expenses shall be allocated reasonably between the income subject to section 631 (c) and the other income. Where a taxpayer has more than one coal royalty contract, expenditures under this section relating to a contract from which no income has been received in the taxable year may not be allocated to income from another contract from which income has been received in the taxable year.

(3) The taxpayer may have expenses which are not attributable even partly to making and administering a coal royalty contract or to the preservation of the economic interest retained under the contract and, accordingly, are not included in the expenditures described in section 272. These include such items as ad valorem taxes imposed by State or local authorities on property not covered by the contract, salaries, wages, or other expenses entirely incident to the ownership and protection of such property and depreciation of improvements thereon, fire insurance on such property, charitable contributions, and similar expenses unrelated to the making or to the administering of coal royalty contracts or preserving the taxpayer's economic interest retained therein.

(e) *Nonapplication of section.* For purposes of section 543 (a) (8) (B), in determining whether the deductions allowable under section 162 constitute 15 percent or more of gross income, the provisions of section 272 shall have no application.

§ 1.273 Statutory provisions; holders of life or terminable interest.

SEC. 273. *Holders of life or terminable interest.* Amounts paid under the laws of a State, a Territory, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time.

§ 1.273–1 Life or terminable interests.

Amounts paid as income to the holder of a life or a terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called by depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deduction for shrinkage or exhaustion thereof due to the passage of time. For the treatment generally of distributions to beneficiaries of an estate or trust, see subparts A, B, C, and D (section 641 and following), subchapter J, chapter 1 of the Code, and the regulations thereunder. For

basis of property acquired from a decedent and by gifts and transfers in trust, see sections 1014 and 1015, and the regulations thereunder.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

DISTRIBUTIONS BY CORPORATIONS

EFFECTS ON RECIPIENTS

§ 1.301 Statutory provisions; distributions of property.

SEC. 301. *Distributions of property*—(a) *In general.* Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) *Amount distributed*—(1) *General rule.* For purposes of this section, the amount of any distribution shall be—

(A) *Noncorporate distributees.* If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) *Corporate distributees.* If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) The fair market value of the other property received; or

(ii) The adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311.

(2) *Reduction for liabilities.* The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) The amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) The amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) *Determination of fair market value.* For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) *Amount taxable.* In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.* That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) *Amount applied against basis.* That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) *Amount in excess of basis*—(A) *In general.* Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) *Distributions out of increase in value accrued before March 1, 1913.* That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the exent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) *Basis.* The basis of property received in a distribution to which subsection (a) applies shall be—

(1) *Noncorporate distributees.* If the shareholder is not a corporation, the fair market value of such property.

(2) *Corporate distributees.* If the shareholder is a corporation, whichever of the following is the lesser:

(A) The fair market value of such property; or

(B) The adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311.

(e) *Exception for certain distributions by personal service corporations.* Any distribution made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 (40 Stat. 1070), or section 218 of the Revenue Act of 1921 (42 Stat. 245), shall be exempt from tax to the distributees.

(f) *Special rules.* (1) For distributions in redemption of stock, see section 302.

(2) For distributions in partial or complete liquidation, see part II (sec. 331 and following).

(3) For distributions in corporate organizations and reorganizations, see part III (sec. 351 and following).

(4) For partial exclusion from gross income of dividends received by individuals, see section 116.

§ 1.301–1 Rules applicable with respect to distributions of money and other property.

(a) *General.* Section 301 provides the general rule for treatment of distributions on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock. The term "property" is defined in section 317 (a). Such distributions, except as otherwise provided in this chapter, shall be treated as provided in section 301 (c). Under section 301 (c), distributions may be included in gross income, applied against and reduce the adjusted basis of the stock, treated as gain from the sale or exchange of property, or (in the case of certain distributions out of increase in value accrued before March 1, 1913) may be exempt from tax. The amount of the distributions to which section 301 applies is determined in accordance with the provisions of section 301 (b). The basis of property received in a distribution to which section 301 applies is determined in accordance with the provisions of section 301 (d). Accordingly, except as otherwise provided in this chapter, a distribution on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock shall be included in gross income to the extent the amount distributed is considered a dividend under section 316. For examples of distributions treated otherwise, see sections 116, 301 (c) (2), 301 (c) (3) (B), 301 (e), 302 (b), 303, and 305. See also part II (relating to distributions in partial or complete liquidation), part III (relating to corporate organizations and reorganizations), and part IV (relating to insolvency reorganizations), subchapter C, chapter 1 of the Code.

(b) *Time of inclusion in gross income and of determination of fair market value.* A distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. However, if such distribution is a distribution other than in cash, the fair market value of the property shall be determined as of the date of distribution without regard to whether such date is the same as that on which the distribution is includible in gross income. For example, if a corporation distributes a taxable dividend in property (the adjusted basis of which exceeds its fair market value on December 31, 1955) on December 31, 1955, which is received by, or unqualifiedly made subject to the demand of, its shareholders on January 2, 1956, the amount to be included in the gross income of the shareholders will be the fair market value of such property on December 31, 1955, although such amount will not be includible in the gross income of the shareholders until January 2, 1956.

(c) *Application of section to shareholders.* Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.

(d) *Distributions of property to corporate shareholders.* If property (other than money and other than the obligations of the distributing corporation) is distributed in kind to a shareholder which is a corporation and the fair market value of such property is greater than the adjusted basis in the hands of the distributing corporation, only the adjusted basis of such property (determined immediately before the distribution and increased for any gain recognized to the distributing corporation under section 311 (b) and (c)) shall be taken into account under section 301 (c). Thus, in such a case, the amount of such a dividend in kind under section 301 (c) (1) may not exceed such adjusted basis. Similarly, in such cases where the distribution is not out of earnings and profits, the amount of the reduction in basis of the shareholder's stock and the amount of any gain resulting from such distribution are determined by reference to the adjusted basis of the property distributed. If the property distributed is money, the amount of the distribution shall be the amount of such money. If the property distributed consists of the obligations of the distributing corporation, or stock of the distributing corporation treated as property under section 305 (b), or rights to acquire such stock treated as property under section 305 (b), the amount of such distribution shall be an amount equal to the fair market value of such obligations, stock, or rights. For special rule as to certain distributions of property received by a domestic corporation from a foreign corporation, see section 902 (d).

(e) *Adjusted basis.* In determining the adjusted basis of property distributed in the hands of the distributing corporation immediately before the distribution for purposes of section 301 (b) (1) (B) (ii) and (d) (2) (B), the basis to be used shall be the basis for determining gain upon a sale or exchange.

(f) *Examples.* The application of section 301 may be illustrated by the following examples:

Example (1). On January 1, 1955, A, an individual owned all of the stock of Corporation M with an adjusted basis of $2,000. During 1955, A received distributions from Corporation M totaling $30,000, consisting of $10,000 in cash and listed securities having a

basis in the hands of Corporation M and a fair market value on the date distributed of $20,000. Corporation M's taxable year is the calendar year. As of December 31, 1954, Corporation M had earnings and profits accumulated after February 28, 1913, in the amount of $26,000, and it had no earnings and profits and no deficit for 1955. Of the $30,000 received by A, $26,000 will be treated as an ordinary dividend; the remaining $4,000 will be applied against the adjusted basis of his stock; the $2,000 in excess of the adjusted basis of his stock will either be treated as gain from the sale or exchange of property (under section 301 (c) (3) (A)) or, if out of increase in value accrued before March 1, 1913, will (under section 301 (c) (3) (B)) be exempt from tax. If A subsequently sells his stock in Corporation M, the basis for determining gain or loss on the sale will be zero.

Example (2). The facts are the same as in Example 1 with the exceptions that the shareholder of Corporation M is Corporation W and that the securities which were distributed had an adjusted basis to Corporation M of $15,000. The distribution received by Corporation W totals $25,000 consisting of $10,000 in cash and securities with an adjusted basis of $15,000. The total $25,000 will be treated as a dividend to Corporation W since the earnings and profits of Corporation M ($26,000) are in excess of the amount of the distribution.

Example (3). Corporation X owns timber land which it acquired prior to March 1, 1913, at a cost of $50,000 with $5,000 allocated as the separate cost of the land. On March 1, 1913, this property had a fair market value of $150,000 of which $135,000 was attributable to the timber and $15,000 to the land. All of the timber was cut prior to 1955 and the full appreciation in the value thereof, $90,000 ($135,000−$45,000), realized through depletion allowances based on March 1, 1913, value. None of this surplus from realized appreciation had been distributed. In 1955, Corporation X sold the land for $20,000 thereby realizing a gain of $15,000. Of this gain, $10,000 is due to realized appreciation in value which accrued before March 1, 1913 $15,000−$5,000). Of the gain of $15,000, $5,000 is taxable. Therefore, at December 31, 1955, Corporation X had a surplus from realized appreciation in the amount of $100,000. It had no accumulated earnings and profits and no deficit at January 1, 1955. The net earnings for 1955 (including the $5,000 gain on the sale of the land) were $20,000. During 1955, Corporation X distributed $75,000 to its stockholders. Of this amount, $20,000 will be treated as a dividend. The remaining $55,000, which is a distribution of realized appreciation, will be applied against and reduce the adjusted basis of the shareholders' stock. If any part of the $55,000 is in excess of the adjusted basis of a shareholder's stock, such part will be exempt from tax.

(g) *Reduction for liabilities.* For the purpose of section 301 (a), the amount of any distribution shall be reduced by—

(1) The amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(2) The amount of any liability to which the property received by the shareholder is subject immediately before and immediately after the distribution.

Such reduction, however, shall not cause the amount of the distribution to be reduced below zero.

(h) *Basis.* The basis of property received in the distribution to which section 301 applies shall be—

(1) If the shareholder is not a corporation, the fair market value of such property;

(2) If the shareholder is a corporation—

(i) In the case of a distribution of the obligations of the distributing corporation or of the stock of such corporation or rights to acquire such stock (if such stock or rights are treated as property under section 305 (b)), the fair market value of such obligations, stock, or rights;

(ii) In the case of the distribution of any other property, whichever of the following is the lesser—

(*a*) The fair market value of such property; or

(*b*) The adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property increased in the amount of gain to the distributing corporation which is recognized under section 311 (b) (relating to distributions of LIFO inventory) or under section 311 (c) (relating to distributions of property subject to liabilities in excess of basis).

(i) [Reserved]

(j) *Transfers for less than fair market value.* If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. If property is transferred in a sale or exchange by a corporation to a shareholder which is a corporation, for an amount less than its fair market value and also less than its adjusted basis, such shareholder shall be treated as having received a distribution to which section 301 applies, and—

(1) Where the fair market value of the property equals or exceeds its adjusted basis in the hands of the distributing corporation the amount of the distribution shall be the excess of the adjusted basis over the amount paid for the property;

(2) Where the fair market value of the property is less than its adjusted basis in the hands of the distributing corporation, the amount of the distribution shall be the excess of such fair market value over the amount paid for the property.

In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

(k) *Application of rule respecting transfers for less than fair market value.* The application of paragraph (j) of this section may be illustrated by the following example:

Example. On January 1, 1955, A, an individual shareholder of Corporation X, purchased property from that corporation for $20. The fair market value of such property was $100, and its basis in the hands of Corporation X was $25. The amount of the distribution determined under section 301 (b) is $80. If A were a corporation, the amount of the distribution would be $5, the excess of the basis of the property in the hands of Corporation X over the amount received therefor. The basis of such property to Corporation A would be $25. If the basis of the property in the hands of Corporation X were $10, the corporate shareholder, A, would not receive a distribution. The basis of such property to Corporation A would be $20. Whether or not A is a corporation, the excess of the amount paid over the basis of the property in the hands of Corporation X ($20 over $10) would be a taxable gain to Corporation X.

(l) *Transactions treated as distributions.* A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property. For example, if a corporation having only common stock outstanding, exchanges one share of newly issued common stock and one bond in the principal amount of $10 for each share of outstanding common stock, the distribution of the bonds will be a distribution of property (to the extent of their fair market value) to which section 301 applies, even though the exchange of common stock for common stock may be pursuant to a plan of reorganization under the terms of section 368 (a) (1) (E) (recapitalization) and even though the exchange of common stock for common stock may be tax free by virtue of section 354.

(m) *Cancellation of indebtedness.* The cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property.

(n) *Cross references.* For certain rules relating to adjustments to earnings and profits and for determining the extent to which a distribution is a dividend, see sections 312 and 316 and regulations thereunder.

§ 1.302 Statutory provisions; distributions in redemption of stock.

SEC. 302. *Distributions in redemption of stock*—(a) *General rule.* If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions treated as exchanges*—(1) *Redemptions not equivalent to dividends.* Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock*—(A) *In general.* Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation.* This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions.* For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) The ratio which the voting stock of the corporation owned by the shareholder

immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) The ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions.* This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) *Termination of shareholder's interest.* Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Stock issued by railroad corporations in certain reorganizations.* Subsection (a) shall apply if the redemption is of stock issued by a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

(5) *Application of paragraphs.* In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c) (2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) *Constructive ownership of stock*—(1) *In general.* Except as provided in paragraph (2) of this subsection, section 318 (a) shall apply in determining the ownership of stock for purposes of this section.

(2) *For determining termination of interest.* (A) In the case of a distribution described in subsection (b) (3), section 318 (a) (1) shall not apply if—

(i) Immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) The distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) The distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary or his delegate) notifies the Secretary or his delegate of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) Any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318 (a), or

(ii) Any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318 (a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(d) *Redemptions treated as distributions of property.* Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317 (b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

(e) *Cross references.* For special rules relating to redemption—

(1) *Death taxes.* Of stock to pay death taxes, see section 303.

(2) *Section 306 stock.* Of section 306 stock, see section 306.

(3) *Liquidations.* Of stock in partial or complete liquidation, see section 331.

§ 1.302–1 General.

(a) Under section 302(d), unless otherwise provided in subchapter C, chapter 1 of the Code, a distribution in redemption of stock shall be treated as a distribution of property to which section 301 applies if the distribution is not within any of the provisions of section 302 (b). A distribution in redemption of stock shall be considered a distribution in part or full payment in exchange for the stock under section 302 (a) provided paragraph (1), (2), (3), or (4) of section 302 (b) applies. Section 318 (a) (relating to constructive ownership of stock) applies to all redemptions under section 302 except that in the termination of a shareholder's interest certain limitations are placed on the application of section 318 (a) (1) by section 302 (c) (2). The term "redemption of stock" is defined in section 317 (b). Section 302 does not apply to that portion of any distribution which qualifies as a distribution in partial liquidation under section 346. For special rules relating to redemption of stock to pay death taxes see section 303. For special rules relating to redemption of section 306 stock see section 306. For special rules relating to redemption of stock in partial or complete liquidation see section 331.

(b) If, in connection with a partial liquidation under the terms of section 346, stock is redeemed in an amount in excess of the amount specified by section 331 (a) (2), section 302 (b) shall first apply as to each shareholder to which it is applicable without limitation because of section 331 (a) (2). That portion of the total distribution which is used in all redemptions from specific shareholders which are within the terms of section 302 (a) shall be excluded in determining the application of sections 346 and 331 (a) (2). For example, Corporation X has $50,000 which is attributable to the sale of one of two active businesses and which, if distributed in redemption of stock, would qualify as a partial liquidation under the terms of section 346 (b). Corporation X distributes $60,000 to its shareholders in redemption of stock, $20,000 of which is in redemption of all of the stock of shareholder A within the meaning of section 302 (b) (3). The $20,000 distributed in redemption of the stock of shareholder A will be excluded in determining the application of sections 346 and 331 (a) (2). The entire $60,000 will be treated as in part or full payment for stock ($20,000 qualifying under section 302 (a) and $40,000 qualifying under sections 346 and 331 (a) (2)).

§ 1.302–2 Redemptions not taxable as dividends.

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302 (b) (1). See, however, paragraph (b) of this section. For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302 (b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302 (d).

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302 (b) (1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318 (a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time

or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. Distribution in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise. In every case in which a shareholder transfers stock to the corporation which issued such stock in exchange for property, the facts and circumstances shall be reported on his return except as provided in paragraph (d) of § 1.331–1. See sections 346(a) and 6043 for requirements relating to returns by corporations.

(c) In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. The following examples illustrate the application of this rule:

Example (1). A, an individual, purchased all of the stock of Corporation X for $100,000. In 1955 the corporation redeems half of the stock for $150,000, and it is determined that this amount constitutes a dividend. The remaining stock of Corporation X held by A has a basis of $100,000.

Example (2). H and W, husband and wife, each own half of the stock of Corporation X. All of the stock was purchased by H for $100,000 cash. In 1950 H gave one-half of the stock to W, the stock transferred having a value in excess of $50,000. In 1955 all of the stock of H is redeemed for $150,000, and it is determined that the distribution to H in redemption of his shares constitutes the distribution of a dividend. Immediately after the transaction, W holds the remaining stock of Corporation X with a basis of $100,000.

Example (3). The facts are the same as in Example (2) with the additional facts that the outstanding stock of Corporation X consists of 1,000 shares and all but 10 shares of the stock of H is redeemed. Immediately after the transaction, H holds 10 shares of the stock of Corporation X with a basis of $50,000, and W holds 500 shares with a basis of $50,000.

§ 1.302–1 Substantially disproportionate redemption.

(a) Section 302(b)(2) provides for the treatment of an amount received in redemption of stock as an amount received in exchange for such stock if—

(1) Immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock as provided in section 302 (b) (2) (B),

(2) The redemption is a substantially disproportionate redemption within the meaning of section 302 (b) (2) (C), and

(3) The redemption is not pursuant to a plan described in section 302 (b) (2) (D).

Section 318 (a) (relating to constructive ownership of stock) shall apply both in making the disproportionate redemption test and in determining the percentage of stock ownership after the redemption. The requirements under section 302 (b) (2) shall be applied to each shareholder separately and shall be applied only with respect to stock which is issued and outstanding in the hands of the shareholders. Section 302 (b) (2) only applies to a redemption of voting stock or to a redemption of both voting stock and other stock. Section 302 (b) (2) does not apply to the redemption solely of nonvoting stock (common or preferred). However, if a redemption is treated as an exchange to a particular shareholder under the terms of section 302 (b) (2), such section will apply to the simultaneous redemption of nonvoting preferred stock (which is not section 306 stock) owned by such shareholder and such redemption will also be treated as an exchange. Generally, for purposes of this section, stock which does not have voting rights until the happening of an event, such as a default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Subsection 302 (b) (2) (D) provides that a redemption will not be treated as substantially disproportionate if made pursuant to a plan the purpose or effect of which is a series of redemptions which result in the aggregate in a distribution which is not substantially disproportionate. Whether or not such a plan exists will be determined from all the facts and circumstances.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example. Corporation M has outstanding 400 shares of common stock of which A, B, C and D each own 100 shares or 25 percent. No stock is considered constructively owned by A, B, C or D under section 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C. For the redemption to be disproportionate as to any shareholder, such shareholder must own after the redemptions less than 20 percent (80 percent of 25 percent) of the 300 shares of stock then outstanding. After the redemptions, A owns 45 shares (15 percent), B owns 75 shares (25 percent), and C owns 80 shares (26⅔ percent). The distribution is disproportionate only with respect to A.

§ 1.302–4 Termination of shareholder's interest.

Section 302(b)(3) provides that a distribution in redemption of all of the stock of the corporation owned by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock of such shareholder. In determining whether all of the stock of the shareholder has been redeemed, the general rule of section 302 (c) (1) requires that the rules of constructive ownership provided in section 318 (a) shall apply. Section 302 (c) (2), however, provides that section 318 (a) (1) (relating to constructive ownership of stock owned by members of a family) shall not apply where the specific requirements of section 302 (c) (2) are met. The following rules shall be applicable in determining whether the specific requirements of section 302 (c) (2) are met:

(a) The agreement specified in section 302 (c) (2) (A) (iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to his return timely filed for the year in which the distribution described in section 302 (b) (3) occurs. The agreement shall recite that the distributee has not acquired any interest in the corporation (as described in section 302 (c) (2) (A) (i)) since such distribution, and that he agrees to notify the district director for the internal revenue district in which such return is filed of any acquisition of such an interest in the corporation within 30 days after such acquisition if such acquisition occurs within 10 years from the date of such distribution.

(b) The distributee who files an agreement under section 302 (c) (2) (A) (iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.

(c) If stock of a parent corporation is redeemed, section 302(c)(2)(A), relating to acquisition of an interest in the corporation within 10 years after termination shall be applied with reference to an interest both in the parent corporation and any subsidiary of such parent corporation. If stock of a parent corporation is sold to a subsidiary in a transaction described in section 304, section 302(c)(2)(A) shall be applicable to the acquisition of an interest in such subsidiary corporation or in the parent corporation. If stock of a subsidiary corporation is redeemed, section 302(c)(2)(A) shall be applied with reference to an interest both in such subsidiary corporation and its parent. Section 302(c)(2)(A) shall also be applied with respect to an interest in a corporation which is a successor corporation to the corporation the interest in which has been terminated.

(d) For the purpose of section 302 (c) (2) (A) (i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

(e) In the case of a distributee to whom section 302 (b) (3) is applicable, who is a creditor after such transaction, the acquisition of the assets of the corporation in the enforcement of the rights of such creditor shall not be considered an acquisition of an interest in the corporation for purposes of section 302 (c) (2) unless stock of the corporation, its parent corporation, or, in the case of a redemption of stock of a parent corporation, of a subsidiary of such corporation is acquired.

(f) In determining whether an entire interest in the corporation has been terminated under section 302 (b) (3), under all circumstances paragraphs (2), (3), and (4) of section 318 (a) (relating to constructive ownership of stock) shall be applicable.

(g) Section 302 (c) (2) (B) provides that section 302 (c) (2) (A) shall not apply—

(1) If any portion of the stock redeemed was acquired directly or indirectly within the 10-year period ending on the date of the distribution by the distributee from a person, the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318 (a), or

(2) If any person owns (at the time of the distribution) stock, the ownership of which is attributable to the distributee under section 318 (a), such person acquired any stock in the corporation directly or indirectly from the distributee within the 10-year period ending on the date of the distribution, and such stock so acquired from the distributee is not redeemed in the same transaction,

unless the acquisition (described in subparagraph (1) of this paragraph) or the disposition by the distributee (described in subparagraph (2) of this paragraph) did not have as one of its principal purposes the avoidance of Federal income tax. A transfer of stock by the transferor, within the 10-year period ending on the date of the distribution, to a person whose stock would be attributable to the transferor shall not be deemed to have as one of its principal purposes the avoidance of Federal income tax merely because the transferee is in a lower income tax bracket than the transferor.

§ 1.303 Statutory provisions; distributions in redemption of stock to pay death taxes.

SEC. 303. *Distributions in redemption of stock to pay death taxes*—(a) *In general.* A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of—

(1) The estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and

(2) The amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States),

shall be treated as a distribution in full payment in exchange for the stock so redeemed.

(b) *Limitations on application of subsection* (a)—(1) *Period for distribution.* Subsection (a) shall apply only to amounts distributed after the death of the decedent and—

(A) Within the period of limitations provided in section 6501 (a) for the assessment of the Federal estate tax (determined without the application of any provision other than section 6501 (a)), or within 90 days after the expiration of such period, or

(B) If a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final.

(2) *Relationship of stock to decedent's estate*—(A) *In general.* Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate is either—

(i) More than 35 percent of the value of the gross estate of such decedent, or

(ii) More than 50 percent of the taxable estate of such decedent.

(B) *Special rule for stock of two or more corporations.* For purposes of the 35 percent and 50 percent requirements of subparagraph (A), stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as the stock of a single corporation. For the purpose of the 75 percent requirement of the preceding sentence, stock which, at the decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property shall be treated as having been included in determining the value of the decedent's gross estate.

(c) *Stock with substituted basis.* If—

(1) A shareholder owns stock of a corporation (referred to in this subsection as "new stock") the basis of which is determined by reference to the basis of stock of a corporation (referred to in this subsection as "old stock"),

(2) The old stock was included (for Federal estate tax purposes) in determining the gross estate of a decedent, and

(3) Subsection (a) would apply to a distribution of property to such shareholder in redemption of the old stock,

then, subject to the limitation specified in subsection (b) (1), subsection (a) shall apply in respect of a distribution in redemption of the new stock.

§ 1.303–1 General.

Section 303 provides that in certain cases a distribution in redemption of stock, the value of which is included in determining the value of the gross estate of a decedent, shall be treated as a distribution in full payment in exchange for the stock so redeemed.

§ 1.303–2 Requirements.

(a) Section 303 applies only where the distribution is with respect to stock of a corporation the value of whose stock in the gross estate of the decedent for Federal estate tax purposes is an amount in excess of (1) 35 percent of the value of the gross estate of such decedent, or (2) 50 percent of the taxable estate of such decedent. For the purposes of such 35 percent and 50 percent requirements, stock of two or more corporations shall be treated as the stock of a single corporation if more than 75 percent in value of the outstanding stock of each such corporation is included in determining the value of the decedent's gross estate. For the purpose of the 75 percent requirement, stock which, at the decedent's death, represents the surviving spouse's interest in community property shall be considered as having been included in determining the value of the decedent's gross estate.

(b) For the purpose of section 303 (b) (2) (A) (i), the term "gross estate" means the gross estate as computed in accordance with section 2031 (or, in the case of the estate of a decedent nonresident not a citizen of the United States, in accordance with section 2103). For the purpose of section 303 (b) (2) (A) (ii), the term "taxable estate" means the taxable estate as computed in accordance with section 2051 (or, in the case of the estate of a decedent nonresident not a citizen of the United States, in accordance with section 2106).

(c) (1) In determining whether the estate of the decedent is comprised of stock of a corporation of sufficient value to satisfy the percentage requirements of section 303 (b) (2) (A) and section 303 (b) (2) (B), the total value, in the aggregate, of all classes of stock of the corporation includible in determining the value of the gross estate is taken into account. A distribution under section 303 (a) may be in redemption of the stock of the corporation includible in determining the value of the gross estate, without regard to the class of such stock.

(2) The above may be illustrated by the following example:

Example. The gross estate of the decedent has a value of $1,000,000, the taxable estate is $700,000, and the sum of the death taxes and funeral and administration expenses is $275,000. Included in determining the gross estate of the decedent is stock of three corporations which, for Federal estate tax purposes, is valued as follows:

Corporation A:	
Common stock	$100,000
Preferred stock	100,000
Corporation B:	
Common stock	50,000
Preferred stock	350,000
Corporation C:	
Common stock	200,000

The stock of Corporation A and Corporation C included in the estate of the decedent constitutes all of the outstanding stock of both corporations. The stock of Corporation A and the stock of Corporation C, treated as the stock of a single corporation under section 303 (b) (2) (B), has a value in excess of $350,000 (35 percent of the gross estate or 50 percent of the taxable estate). Likewise, the stock of Corporation B has a value in excess of $350,000. The distribution by one or more of the above corporations, within the period prescribed in section 303 (b) (1), of amounts not exceeding, in the aggregate, $275,000, in redemption of preferred stock or common stock of such corporation or corporations, will be treated as in full payment in exchange for the stock so redeemed.

(d) If stock includible in determining the value of the gross estate of a decedent is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, the redemption of the new stock will be treated the same under section 303 as the redemption of the old stock would have been. Thus section 303 shall apply with respect to a distribution in redemption of stock received by the estate of a decedent (1) in connection with a reorganization under section 368, (2) in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355), (3) in an exchange under section 1036 or (4) in a distribution to which section 305 (a) applies. Similarly, a distribution in redemption of stock will qualify under section 303, notwithstanding the fact that the stock redeemed is

section 306 stock to the extent that the conditions of section 303 are met.

(e) Section 303 applies to distributions made after the death of the decedent and (1) before the expiration of the 3-year period of limitations for the assessment of estate tax provided in section 6501 (a) (determined without the application of any provisions of law extending or suspending the running of such period of limitations), or within 90 days after the expiration of such period, or (2) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final. The extension of the period of distribution provided in section 303 (b) (1) (B) has reference solely to bona fide contests in the Tax Court and will not apply in the case of a petition for redetermination of a deficiency which is initiated solely for the purpose of extending the period within which section 303 would otherwise be applicable.

(f) While section 303 will most frequently have application in the case where stock is redeemed from the executor or administrator of an estate, the section is also applicable to distributions in redemption of stock included in the decedent's gross estate and held at the time of the redemption by any person who acquired the stock by any of the means comprehended by part III, subchapter A, chapter 11 of the Code, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust created by the decedent. Thus section 303 may apply with respect to a distribution in redemption of stock from a donee to whom the decedent has transferred stock in contemplation of death where the value of such stock is included in the decedent's gross estate under section 2035. Similarly, section 303 may apply to the redemption of stock from a beneficiary of the estate to whom an executor has distributed the stock pursuant to the terms of the will of the decedent. However, section 303 is not applicable to the case where stock is redeemed from a stockholder who has acquired the stock by gift or purchase from any person to whom such stock has passed from the decedent. Nor is section 303 applicable to the case where stock is redeemed from a stockholder who has acquired the stock from the executor in satisfaction of a specific monetary bequest.

(g) The total application of section 303 with respect to stock included in the gross estate of any decedent can never exceed the sum of the amount of the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of the decedent's death and the amount of funeral and administration expenses allowable as deductions to the estate. In determining whether the total distributions in redemption of such stock made within the period of time prescribed in section 303 (b) (1) exceed the amount of such taxes, interest, and expenses, account shall be taken of all such distributions without regard to whether any distribution would be treated as a dividend were it not for section 303.

(h) For the purpose of section 303, the Federal estate tax or any other estate, inheritance, legacy, or succession tax shall be ascertained after the allowance of any credit, relief, discount, refund, remission or reduction of tax.

§ 1.303–3 Application of other sections.

(a) The sole effect of section 303 is to exempt from tax as a dividend a distribution to which such section is applicable when made in redemption of stock includible in a decedent's gross estate. Such section does not, however, in any other manner affect the principles set forth in sections 302 and 306. Thus, if stock of a corporation is owned equally by A, B, and the C Estate, and the corporation redeems one-half of the stock of each shareholder, the determination of whether the distributions to A and B are essentially equivalent to dividends shall be made without regard to the effect which section 303 may have upon the taxability of the distribution to the C Estate.

(b) See section 304 relative to redemption of stock through the use of related corporations.

§ 1.304 Statutory provisions; redemption through use of related corporations.

SEC. 304. *Redemption through use of related corporations*—(a) *Treatment of certain stock purchases*—(1) *Acquisition by related corporation (other than subsidiary).* For purposes of sections 302 and 303, if—

(A) One or more persons are in control of each of two corporations, and

(B) In return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

(2) *Acquisition by subsidiary.* For purposes of sections 302 and 303, if—

(A) In return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) The issuing corporation controls the acquiring corporation,

then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) *Special rules for application of subsection (a)—(1) Rule for determinations under section 302 (b).* In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302 (b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to constructive ownership of stock) with respect to section 302 (b) for purposes of this paragraph, section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

(2) *Amount constituting dividend—(A) Where subsection (a) (1) applies.* In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

(B) *Where subsection (a) (2) applies.* In the case of any acquisition of stock to which subsection (a) (2) of this section applies, the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation.

(c) *Control—(1) In general.* For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) *Constructive ownership.* Section 318 (a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

§ 1.304–1 General.

Section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Such sales shall be treated as redemptions subject to sections 302 and 303.

§ 1.304–2 Acquisition by related corporation (other than subsidiary).

(a) If a corporation, in return for property, acquires stock of another corporation from one or more persons and the person or persons from whom the stock was acquired were in control of both such corporations before the acquisition, then such property shall be treated as received in redemption of stock of the acquiring corporation. The stock received by the acquiring corporation shall be treated as a contribution to the capital of such corporation and shall have the same basis in its hands as it had in the hands of the transferor. The transferor's basis for his stock in the acquiring corporation shall be increased by the basis of stock surrendered by him. (But see below in this paragraph for subsequent reductions of basis in certain cases.) As to each person transferring stock, the amount received shall be treated as a distribution of property under section 302 (d), unless as to such person such amount is to be treated as received in exchange for the stock under the terms of section 302 (a) or section 303. In applying section 302 (b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to his ownership of stock in the acquiring corporation (except for purposes of applying section 318 (a)). In determining

control and applying section 302 (b), section 318 (a) (relating to the constructive ownership of stock) shall be applied without regard to the 50 percent limitation in section 318 (a) (2) (C). A series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations. If section 302 (d) applies to the surrender of stock by a shareholder, his basis for his stock in the acquiring corporation after the transaction (increased as stated above in this paragraph) shall not be decreased except as provided in section 301. If section 302(d) does not apply, the property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under section 302(a), which stock has a basis equal to the amount by which the shareholder's basis for his stock in the acquiring corporation was increased on account of the contribution to capital as provided for above. Accordingly, such amount shall be applied in reduction of the shareholder's basis for his stock in the acquiring corporation. Thus, the basis of each share of the shareholder's stock in the acquiring corporation will be the same as the basis of such share before the entire transaction. The holding period of the stock which is considered to have been redeemed shall be the same as the holding period of the stock actually surrendered.

(b) In any case in which two or more persons, in the aggregate, control two corporations, section 304 (a) (1) will apply to sales by such persons of stock in either corporation to the other (whether or not made simultaneously) provided the sales by each of such persons are related to each other. The determination of whether the sales are related to each other shall be dependent upon the facts and circumstances surrounding all of the sales. For this purpose, the fact that the sales may occur during a period of one or more years (such as in the case of a series of sales by persons who together control each of such corporations immediately prior to the first of such sales and immediately subsequent to the last of such sales) shall be disregarded, provided the other facts and circumstances indicate related transactions.

(c) The application of section 304 (a) (1) may be illustrated by the following examples:

Example (1). Corporation X and Corporation Y each have outstanding 100 shares of common stock. One-half of the stock of each corporation is owned by an individual, A, and one-half by another individual, B, who is unrelated to A. A sells 40 shares of Corporation X stock to Corporation Y for $50,000, such stock having an adjusted basis of $10,000 to A. After the sale, A is considered as owning Corporation X stock as follows:

(i) 10 shares directly.

(ii) 45 shares constructively since by virtue of his 50 percent ownership of Y, he constructively owns 50 percent of the 40 shares owned directly by Corporation Y, and 50 percent of the 50 shares attributed to Corporation Y because they are owned by Y's stockholder, B.

Since after the sale A owns a total of more than 50 percent of the voting power of all the outstanding stock of Corporation X, the transfer is not "substantially disproportionate" as to him as provided in section 302 (b) (2). Under these facts, section 302 (b) (1) is not applicable and the entire $50,000 is, therefore, treated as a dividend to A to the extent of the earnings and profits of Corporation Y. The basis of the Corporation X stock to Corporation Y is $10,000, its adjusted basis to A. The amount of $10,000 is added to the basis of the stock of Corporation Y in the hands of A.

Example (2). Corporation X and Corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half the stock of each corporation, B owns one-half the stock of Corporation X, and C owns one-half the stock of Corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of Corporation X to Corporation Y for $50,000, such stock having an adjusted basis of $10,000 to him. After the sale, A is considered as owning 35 shares of the stock of Corporation X (20 shares directly and 15 constructively because one-half of the 30 shares owned by Corporation Y are attributed to him). Since before the sale, he owned 50 percent of the stock of Corporation X and after the sale he owned directly and constructively only 35 percent of such stock, the redemption is substantially disproportionate as to him pursuant to the provisions of section 302 (b) (2). He, therefore, realizes a gain of $40,000 ($50,000 minus $10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of Corporation Y is not changed as a result of the entire transaction. The basis to Corporation Y for the stock of Corporation X is $10,000, the basis of the transferor.

Example (3). Corporation X and Corporation Y each have outstanding 100 shares of common stock. H, an individual, W, his wife, S, his son, and G, his grandson, each own 25 shares of stock of each corporation. H sells all of his 25 shares of stock of Corporation X to Corporation Y. Since both before and after the transaction H owned directly and constructively 100 percent of the stock of Corporation X, the amount received by him for his stock of Corporation X is treated as a dividend to him to the extent of the earnings and profits of Corporation Y.

§ 1.304–3 Acquisition by a subsidiary.

(a) If a subsidiary acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as though the parent corporation had redeemed its own stock. For the purpose of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304 (c). The determination whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302 (b) with reference to the stock of the issuing parent corporation. If such distribution would have been treated as a distribution of property (pursuant to section 302 (d)) under section 301, the entire amount of the selling price of the stock shall be treated as a dividend to the seller to the extent of the earnings and profits of the parent corporation determined as if the distribution had been made to it of the property that the subsidiary exchanged for the stock. In such cases, the transferor's basis for his remaining stock in the parent corporation will be determined by including the amount of the basis of the stock of the parent corporation sold to the subsidiary.

(b) Section 304 (a) (2) may be illustrated by the following example:

Example. Corporation M has outstanding 100 shares of common stock which are owned as follows: B, 75 shares, C, son of B, 20 shares, and D, daughter of B, 5 shares. Corporation M owns the stock of Corporation X. B sells his 75 shares of Corporation M stock to Corporation X. Under section 302 (b) (3) this is a termination of B's entire interest in Corporation M and the full amount received from the sale of his stock will be treated as payment in exchange for this stock, provided he fulfills the requirements of section 302 (c) (2) (relating to an acquisition of an interest in the corporations).

§ 1.305 Statutory provisions; distributions of stock and stock rights.

SEC. 305. *Distributions of stock and stock rights.*—(a) *General rule.* Except as provided in subsection (b), gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock.

(b) *Distributions in lieu of money.* Subsection (a) shall not apply to a distribution by a corporation of its stock (or rights to acquire its stock), and the distribution shall be treated as a distribution of property to which section 301 applies—

(1) To the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year; or

(2) If the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either—

(A) In its stock (or in rights to acquire its stock), or

(B) In property.

(c) *Cross references.* For special rules—

(1) Relating to the receipt of stock and stock rights in corporate organizations and reorganizations, see part III (sec. 351 and following).

(2) In the case of a distribution which results in a gift, see section 2501 and following.

(3) In the case of a distribution which has the effect of the payment of compensation, see section 61 (a) (1).

§ 1.305–1 Stock dividends.

Under section 305, a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be included in gross income except as provided in section 305 (b). If the distribution of stock or rights to acquire stock is received in discharge of preference dividends, to the extent that such distribution is not taxable pursuant to section 305, such stock, whether or not preferred stock, or such rights may be section 306 stock within the meaning of section 306 (c). A distribution made by a corporation to its shareholders in its stock or rights to acquire its stock which would not otherwise be included in gross income by reason of section 305 shall not be so treated merely because such distribution was made out of treasury stock or consisted of rights to acquire treasury stock. A right to acquire stock is an option to buy unissued or treasury stock of the corporation issuing the right. See section 307 for rules as to

basis of stock and stock rights acquired in a distribution.

§ 1.305–2 Election of shareholders as to medium of payment.

(a) *General.* If any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock shall be considered as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other; or

(4) Whether all or part of the shareholders have the election.

(b) [Reserved]

(c) *Amount of distribution.* (1) Where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b)(2), the amount of the distribution, in accordance with section 301(b) and § 1.301–1, is the fair market value of such stock or rights on the date of distribution. Accordingly, where a corporation makes a distribution, to which section 305(b)(2) is applicable, which is payable either in property or in its own stock or rights to acquire its stock the amount distributed with respect to all shareholders receiving stock or rights is the fair market value, on the date of distribution, of the stock or rights received. The amount distributed with respect to shareholders receiving property is the fair market value, on the date of distribution, of such property received or, in the case of corporate distributees, the adjusted basis of such property in the hands of the distributing corporation if less than its fair market value. Where a corporation which regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value and, on a date shortly before the distribution, there is a determination of the amount of stock to be distributed to those shareholders who elect to receive stock equal in value to the amount of money that could be received instead, the amount of the distribution of the stock received by any shareholder will be considered to equal the amount of the money which could have been received instead.

(2) The application of section 305(b) may be illustrated by the following examples:

Example (1). (i) Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus $12 principal amount of securities of Corporation Y owned by Corporation X. The fair market value of the stock of Corporation X on the distribution date was $10 per share. The fair market value of $12 principal amount of securities of Corporation Y on the distribution date was $11 but such securities had a cost basis to Corporation X of $9.

(ii) The distribution to all shareholders of one additional share of stock of Corporation X (with respect to which no election applies) for each share outstanding is not a distribution to which section 301 applies.

(iii) The distribution of the second share of stock of Corporation X to those shareholders who do not elect to receive securities of Corporation Y is a distribution of property to which section 301 applies, whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies is $10 per share of stock of Corporation X held on the record date (the fair market value of the stock of Corporation X on the distribution date).

(iv) The distribution of securities of Corporation Y in lieu of the second share of stock of Corporation X to the shareholders of Corporation X, whether individuals or corporations, who elect to receive such securities, is also a distribution of property to which section 301 applies.

(v) In the case of the individual shareholders of Corporation X who elect to receive such securities, the amount of the distribution to which section 301 applies is $11 per share of stock of Corporation X held on the record date (the fair market value of the $12 principal amount of securities of Corporation Y on the distribution date).

(vi) In the case of the corporate shareholders of Corporation X electing to receive such securities, the amount of the distribution to which section 301 applies is $9 per share of stock of Corporation X held on the record date (the basis of the securities of Corporation Y in the hands of Corporation X).

Example (2). On January 10, 1960, Corporation X, a regulated investment company, declared a dividend of $1 per share on its common stock payable on February 11, 1960, in cash or in stock of Corporation X of equivalent value determined as of January 22, 1960, at the election of the shareholder made on or before January 22, 1960. The amount of the distribution to which section 301 applies is $1 per share whether the shareholder elects to take cash or stock and whether the shareholder is an individual or a corporation. Such amount will also be used in determining the dividend paid deduction of Corporation X and the reduction in earnings and profits of Corporation X.

§ 1.305–3 Distributions in discharge of preference dividends.

A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a distribution of property to which section 301 applies to the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year.

§ 1.306 Statutory provisions; dispositions of certain stock.

SEC. 306. *Dispositions of certain stock*—(a) *General rule.* If a shareholder sells or otherwise disposes of section 306 stock (as defined in subsection (c))—

(1) *Dispositions other than redemptions.* If such disposition is not a redemption (within the meaning of section 317 (b))—

(A) The amount realized shall be treated as gain from the sale of property which is not a capital asset. This subparagraph shall not apply to the extent that—

(i) The amount realized, exceeds

(ii) Such stock's ratable share of the amount which would have been a dividend at the time of distribution if (in lieu of section 306 stock) the corporation had distributed money in an amount equal to the fair market value of the stock at the time of distribution.

(B) Any excess of the amount realized over the sum of—

(i) The amount treated under subparagraph (A) as gain from the sale of property which is not a capital asset, plus

(ii) The adjusted basis of the stock,

shall be treated as gain from the sale of such stock.

(C) No loss shall be recognized.

(2) *Redemption.* If the disposition is a redemption, the amount realized shall be treated as a distribution of property to which section 301 applies.

(b) *Exceptions.* Subsection (a) shall not apply—

(1) *Termination of shareholder's interest*—(A) *Not in redemption.* If the disposition—

(i) Is not a redemption;

(ii) Is not, directly or indirectly, to a person the ownership of whose stock would (under section 318 (a)) be attributable to the shareholder; and

(iii) Terminates the entire stock interest of the shareholder in the corporation (and for purposes of this clause, section 318 (a) shall apply).

(B) *In redemption.* If the disposition is a redemption and section 302 (b) (3) applies.

(2) *Liquidations.* If the section 306 stock is redeemed in a distribution in partial or complete liquidation to which part II (sec. 331 and following) applies.

(3) *Where gain or loss is not recognized.* To the extent that, under any provision of this subtitle, gain or loss to the shareholder is not recognized with respect to the disposition of the section 306 stock.

(4) *Transactions not in avoidance.* If it is established to the satisfaction of the Secretary or his delegate—

(A) That the distribution, and the disposition or redemption, or

(B) In the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,

was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(c) *Section 306 stock defined*—(1) *In general.* For purposes of this subchapter, the term "section 306 stock" means stock which meets the requirements of subparagraph (A), (B), or (C) of this paragraph.

(A) *Distributed to seller.* Stock (other than common stock issued with respect to common stock) which was distributed to the shareholder selling or otherwise disposing of such stock if, by reason of section 305 (a), any part of such distribution was not includible in the gross income of the shareholder.

(B) *Received in a corporate reorganization or separation.* Stock which is not common stock and—

(i) Which was received, by the shareholder selling or otherwise disposing of such stock, in pursuance of a plan of reorganization (within the meaning of section 368 (a)), or in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applied, and

(ii) With respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of part III, but only to the extent that either the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock.

For purposes of this section, a receipt of stock to which the foregoing provisions of this subparagraph apply shall be treated as a distribution of stock.

(C) *Stock having transferred or substituted basis.* Except as otherwise provided in subparagraph (B), stock the basis of which (in the hands of the shareholder selling or otherwise disposing of such stock) is determined by reference to the basis (in the hands of such shareholder or any other person) of section 306 stock.

(2) *Exception where no earnings and profits.* For purposes of this section, the term "section 306 stock" does not include any stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock.

(d) *Stock rights.* For purposes of this section—

(1) Stock rights shall be treated as stock, and

(2) Stock acquired through the exercise of stock rights shall be treated as stock distributed at the time of the distribution of the stock rights, to the extent of the fair market value of such rights at the time of the distribution.

(e) *Convertible stock.* For purposes of subsection (c)—

(1) If section 306 stock was issued with respect to common stock and later such section 306 stock is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in the section 306 stock), then (except as provided in paragraph (2)) the common stock so received shall not be treated as section 306 stock; and

(2) Common stock with respect to which there is a privilege of converting into stock other than common stock (or into property), whether or not the conversion privilege is contained in such stock, shall not be treated as common stock.

(f) *Source of gain.* The amount treated under subsection (a) (1) (A) as gain from the sale of property which is not a capital asset shall, for purposes of part I of subchapter N (sec. 861 and following, relating to determination of sources of income), be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If under the preceding sentence such amount is determined to be derived from sources within the United States, such amount shall be considered to be fixed or determinable annual or periodical gains, profits, and income within the meaning of section 871 (a) or section 881 (a), as the case may be.

(g) *Change in terms and conditions of stock.* If a substantial change is made in the terms and conditions of any stock, then, for purposes of this section—

(1) The fair market value of such stock shall be the fair market value at the time of the distribution or at the time of such change, whichever such value is higher;

(2) Such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined as of the time of distribution or as of the time of such change, whichever such ratable share is higher; and

(3) Subsection (c) (2) shall not apply unless the stock meets the requirements of such subsection both at the time of such distribution and at the time of such change.

(h) *Stock received in distributions and reorganizations to which 1939 Code applied.* If stock—

(1) Was received in a distribution or reorganization to which the Internal Revenue Code of 1939 (or the corresponding provisions of prior law) applied,

(2) Such stock would have been section 306 stock if this Code applied to such distribution or reorganization, and

(3) Such stock is disposed of or redeemed on or after June 22, 1954,

then the foregoing subsections of this section shall not apply in respect of such disposition or redemption. The extent to which such disposition or redemption shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 (as modified by the provisions of this Code other than the foregoing subsections of this section) continued to apply in respect of such disposition or redemption.

§ 1.306–1 General.

(a) Section 306 provides, in general, that the proceeds from the sale or redemption of certain stock (referred to as "section 306 stock") shall be treated either as gain from the sale of property which is not a capital asset, or as a distribution of property to which section 301 applies. Section 306 stock is defined in section 306(c) and is usually preferred stock received either as a nontaxable dividend or in a transaction in which no gain or loss is recognized. Section 306 (b) lists certain circumstances in which the special rules of section 306(a) shall not apply.

(b) (1) If a shareholder sells or otherwise disposes of section 306 stock (other than by redemption or within the exceptions listed in section 306 (b)), the entire proceeds received from such disposition shall be treated as gain from the sale of property not a capital asset to the extent that the fair market value of the stock sold, on the date distributed to the shareholder, would have been a dividend to such shareholder had the distributing corporation distributed cash in lieu of stock. Any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock disposed of, shall be treated as gain from the sale of a capital asset or noncapital asset as the case may be. No loss shall be recognized. While the amount of earnings and profits at the time of the distribution is one of the measures of the amount to be treated as ordinary income, no reduction of earnings and profits results from any disposition of stock other than a redemption. The term "disposition" under section 306 (a) (1) includes, among other things, pledges of stock under certain circumstances, particularly where the pledgee can look only to the stock itself as its security.

(2) Section 306 (a) (1) may be illustrated by the following examples:

Example (1). On December 15, 1954, A and B owned equally all of the stock of Corporation X which files its income tax return on a calendar year basis. On that date Corporation X distributed pro rata 100 shares of preferred stock as a dividend on its outstanding common stock. On December 15, 1954, the preferred stock had a fair market value of $10,000. On December 31, 1954, the earnings and profits of Corporation X were $20,000. The 50 shares of preferred stock so distributed to A had an allocated basis to him of $10 per share or a total of $500 for the 50 shares. Such shares had a fair market value of $5,000 when issued. A sold the 50 shares of preferred stock on July 1, 1955, for $6,000. Of this amount $5,000 will be treated as gain from the sale of property which is not a capital asset; $500 ($6,000 minus $5,500) will be treated as gain from the sale of a capital or noncapital asset as the case may be.

Example (2). The facts are the same as in Example 1 except that A sold his 50 shares of preferred stock for $5,100. Of this amount $5,000 will be treated as gain from the sale of property which is not a capital asset. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $400, the allocated basis of $500 reduced by the $100 received.

Example (3). The facts are the same as in example 1 except that A sold 25 of his shares of preferred stock for $2,600. Of this amount $2,500 will be treated as gain from the sale of property which is not a capital asset. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, $150, the allocated basis of $250 reduced by the $100 received.

(c) The entire amount received by a shareholder from the redemption of section 306 stock shall be treated as a distribution of property under section 301. In the case of a redemption, the amount of the earnings and profits of the distributing corporation at the time the section 306 stock was distributed is immaterial. See also section 303 (relating to distribution in redemption of stock to pay death taxes).

§ 1.306–2 Exception.

(a) If a shareholder terminates his entire stock interest in a corporation,

(1) By a sale or other disposition within the requirements of section 306 (b) (1) (A), or

(2) By redemption under section 302 (b) (3), (through the application of section 306 (b) (1) (B)),

the amount received from such disposition shall be treated as an amount received in part or full payment for the stock sold or redeemed. In the case of a sale, only the stock interest need be terminated. In determining whether an entire stock interest has been terminated under section 306 (b) (1) (A), all of the provisions of section 318 (a) (relating to constructive ownership of stock) shall be applicable. In determining whether a shareholder has terminated his entire interest in a corporation by a redemption of his stock under section 302 (b) (3), all of the provisions of section 318 (a) shall be applicable unless the shareholder meets the requirements of section 302 (c) (2) (relating to termination of all interest in the corporation). If the requirements of section 302 (c) (2) are met, section 318 (a) (1) (relating to members of a family) shall be inapplicable. Under all circumstances paragraphs (2), (3), and (4) of section 318 (a) shall be applicable.

(b) Section 306 (a) does not apply to—

(1) Redemptions of section 306 stock pursuant to a partial or complete liquidation of a corporation to which part II

(section 331 and following), subchapter C, chapter 1 of the Code applies,

(2) Exchanges of section 306 stock solely for stock in connection with a reorganization or in an exchange under section 351, 355, or section 1036 (relating to exchanges of stock for stock in the same corporation) to the extent that gain or loss is not recognized to the shareholder as the result of the exchange of the stock (see paragraph (d) of § 1.306–3 relative to the receipt of other property), and

(3) A disposition or redemption, if it is established to the satisfaction of the Commissioner that the distribution, and the disposition or redemption, was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. However, in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, it is not necessary to establish that the distribution was not in pursuance of such a plan. For example, in the absence of such a plan and of any other facts the first sentence of this subparagraph would be applicable to the case of dividends and isolated dispositions of section 306 stock by minority shareholders. Similarly, in the absence of such a plan and of any other facts, if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a disposition one of the principal purposes of which is the avoidance of Federal income tax.

§ 1.306–3 Section 306 stock defined.

(a) For the purpose of subchapter C, chapter 1 of the Code, the term "section 306 stock" means stock which meets the requirements of section 306(c)(1). Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, provided the distributing corporation has earnings and profits at the time of distribution and for this purpose the total amount of the earnings and profits is immaterial. However, except as provided in section 306(g), if the distributing corporation has no earnings and profits at the time of distribution, pursuant to section 306(c)(2), the stock distributed will not constitute section 306 stock.

(b) For the purpose of section 306, rights to acquire stock shall be treated as stock. Such rights shall not be section 306 stock if no part of the distribution would have been a dividend if money had been distributed in lieu of such rights. If money distributed in lieu of such rights would have been a dividend, the amount referred to in section 306 (a) (1) (A) (ii) shall be determined as of the time of the distribution of such rights. When stock is acquired by the exercise of rights which are section 306 stock, the stock acquired is section 306 stock, and the amount referred to in section 306 (a) (1) (A) (ii) is determined by reference to the date of distribution of the rights.

(c) Section 306 (c) (1) (A) provides that section 306 stock is any stock (other than common issued with respect to common) distributed to the shareholder selling or otherwise disposing thereof if, under section 305 (a) (relating to distributions of stock and stock rights) any part of the distribution was not included in the gross income of the distributee. Common stock received as a stock dividend will not be considered as section 306 stock unless such dividend is (1) distributed with respect to stock which is not common stock, and (2) is not taxable upon receipt. For example, common stock distributed in payment of arrearages on preferred stock dividends may be section 306 stock unless the common stock is taxable under section 305 (b) (1). Thus, where part of the distribution is in payment of the dividends for the current and preceding year on preferred stock and part of the distribution relates to arrearages on such stock, only that part of the distribution applying to arrearages will be treated as section 306 stock. For example, if 100 shares of common stock are distributed in payment of all dividends due on preferred stock, one-tenth of such stock applying to the current and immediately preceding year's dividends and nine-tenths to arrearages, only nine-tenths of each share may be section 306 stock.

(d) Section 306 (c) (1) (B) includes in the definition of section 306 stock any stock except common stock, which is received by a shareholder in connection with a reorganization under section 368 or in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355) provided the effect of the transaction is substantially the same as the receipt of a stock dividend, or the stock is received in exchange for section 306 stock. If, in a transaction to which section 356 is applicable, a shareholder exchanges section 306 stock for stock and money or other property, the entire amount of such money and of the fair market value of the other property (not limited to the gain recognized) shall be treated as a distribution of property to which section 301 applies. Common stock received in exchange for section 306 stock in a recapitalization shall not be considered section 306 stock. Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368 (a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a dividend under section 356 (a) (2) or would have been treated as a distribution to which section 301 applies by virtue of section 356 (b) or section 302 (d). The application of the preceding sentence is illustrated by the following examples:

Example (1). Corporation A, having only common stock outstanding, is merged in a statutory merger (qualifying as a reorganization under section 368 (a)) with Corporation B. Pursuant to such merger, the shareholders of Corporation A received both common and preferred stock in Corporation B. The preferred stock received by such shareholders is section 306 stock.

Example (2). X and Y each own one-half of the 2,000 outstanding shares of preferred stock and one-half of the 2,000 outstanding shares of common stock of Corporation C. Pursuant to a reorganization within the meaning of section 368 (a) (1) (E) (recapitalization) each shareholder exchanges his preferred stock for preferred stock of a new issue which is not substantially different from the preferred stock previously held. Unless the preferred stock exchanged was itself section 306 stock the preferred stock received is not section 306 stock.

(e) Section 306 (c) (1) (C) includes in the definition of section 306 stock any stock (except as provided in section 306 (c) (1) (B)) the basis of which in the hands of the person disposing of such stock, is determined by reference to section 306 stock held by such shareholder or any other person. Under this paragraph common stock can be section 306 stock. Thus, if a person owning section 306 stock in Corporation A transfers it to Corporation B which is controlled by him in exchange for common stock of Corporation B in a transaction to which section 351 is applicable, the common stock so received by him would be section 306 stock and subject to the provisions of section 306 (a) on its disposition. In addition, the section 306 stock transferred is section 306 stock in the hands of Corporation B, the transferee. Section 306 stock transferred by gift remains section 306 stock in the hands of the donee. Stock received in exchange for section 306 stock under section 1036 (a) (relating to exchange of stock for stock in the same corporation) or under so much of section 1031 (b) as relates to section 1036 (a) becomes section 306 stock and acquires, for purposes of section 306, the characteristics of the section 306 stock exchanged. The entire amount of the fair market value of the other property received in such transaction shall be considered as received upon a disposition (other than a redemption) to which section 306 (a) applies. Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death or the optional valuation date under section 1014.

(f) If section 306 stock which was distributed with respect to common stock is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in section 306 stock), such common stock shall not be section 306 stock. This paragraph applies to exchanges not coming within the purview of section 306 (c) (1) (B). Common stock which is convertible into stock other than common stock or into property, shall not be considered common stock. It is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.

(g) If there is a substantial change in the terms and conditions of any stock, then, for the purpose of this section—

(1) The fair market value of such stock shall be the fair market value at

the time of distribution or the fair market value at the time of such change, whichever is higher;

(2) Such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined as of the time of distribution or as of the time of such change, whichever ratable share is higher; and

(3) Section 306 (c) (2) shall be inapplicable if there would have been a dividend to any extent if money had been distributed in lieu of the stock either at the time of the distribution or at the time of such change.

(h) When section 306 stock is disposed of, the amount treated under section 306 (a) (1) (A) as gain from the sale of property which is not a capital asset will, for the purposes of part I, subchapter N, chapter 1 of the Code, be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If the amount is determined to be derived from sources within the United States, the amount shall be considered to be fixed or determinable annual or periodic gains, profits, and income within the meaning of section 871 (a) or section 881 (a), relating, respectively, to the tax on nonresident alien individuals and on foreign corporations not engaged in business in the United States.

(i) Section 306 shall be inapplicable to stock received before June 22, 1954, and to stock received on or after June 22, 1954, in transactions subject to the provisions of the Internal Revenue Code of 1939. See § 1.391–1.

§ 1.307 Statutory provisions; basis of stock and stock rights acquired in distributions.

SEC. 307. *Basis of stock and stock rights acquired in distributions*—(a) *General rule.* If a shareholder in a corporation receives its stock or rights to acquire its stock (referred to in this subsection as "new stock") in a distribution to which section 305 (a) applies, then the basis of such new stock and of the stock with respect to which it is distributed (referred to in this section as "old stock"), respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be made under regulations prescribed by the Secretary or his delegate.

(b) *Exception for certain stock rights*—(1) *In general.* If—

(A) A corporation distributes rights to acquire its stock to a shareholder in a distribution to which section 305 (a) applies, and

(B) The fair market value of such rights at the time of the distribution is less than 15 percent of the fair market value of the old stock at such time,

then subsection (a) shall not apply and the basis of such rights shall be zero, unless the taxpayer elects under paragraph (2) of this subsection to determine the basis of the old stock and of the stock rights under the method of allocation provided in subsection (a).

(2) *Election.* The election referred to in paragraph (1) shall be made in the return filed within the time prescribed by law (including extensions thereof) for the taxable year in which such rights were received. Such election shall be made in such manner as the Secretary or his delegate may by regulations prescribe, and shall be irrevocable when made.

(c) *Cross Reference.* For basis of stock and stock rights distributed before June 22, 1954, see section 1052.

§ 1.307–1 General.

(a) If a shareholder receives stock or stock rights as a distribution on stock previously held and under section 305 such distribution is not includible in gross income then, except as provided in section 307(b) and § 1.307–2, the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and pursuant to section 305 part of the distribution is not includible in gross income, then (except as provided in section 307 (b) and § 1.307–2) the basis of the stock with respect to which the distribution is made shall be allocated between (1) the old stock and (2) that part of the new stock or rights which is not includible in gross income, in proportion to the fair market values of each on the date of distribution. The date of distribution in each case shall be the date the stock or the rights are distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example. A taxpayer in 1947 purchased 100 shares of common stock at $100 per share and in 1954 by reason of the ownership of such stock acquired 100 rights entitling him to subscribe to 100 additional shares of such stock at $90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of $110 and the rights had a fair market value of $19 each. The basis of the rights and the common stock for the purpose of determining the basis for gain or loss on a subsequent sale or exercise of the rights or a sale of the old stock is computed as follows:

100 (shares) × $100 = $10,000, cost of old stock (stock in respect of which the rights were acquired).

100 (shares) × $110 = $11,000, market value of old stock.

100 (rights) × $19 = $1,900, market value of rights.

$\frac{11,000}{12,900}$ of $10,000 = $8,527.13, cost of old stock apportioned to such stock.

$\frac{1,900}{12,900}$ of $10,000 = $1,472.87, cost of old stock apportioned to rights.

If the rights are sold, the basis for determining gain or loss will be $14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor ($90) plus the basis of the rights exercised ($14.7287 each) or $104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be $85.2713 per share.

§ 1.307–2 Exception.

The basis of rights to buy stock which are excluded from gross income under section 305(a), shall be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided in paragraph (a) of § 1.307–1. The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.

EFFECTS ON CORPORATION

§ 1.311 Statutory provisions; taxability of corporation on distribution.

SEC. 311. *Taxability of corporation on distribution*—(a) *General rule.* Except as provided in subsections (b) and (c) of this section and section 453 (d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

(1) Its stock (or rights to acquire its stock), or

(2) Property.

(b) *LIFO inventory*—(1) *Recognition of gain.* If a corporation inventorying goods under the method provided in section 472 (relating to last-in, first-out inventories) distributes inventory assets (as defined in paragraph (2) (A)), then the amount (if any) by which—

(A) The inventory amount (as defined in paragraph (2) (B)) of such assets under a method authorized by section 471 (relating to general rule for inventories), exceeds

(B) The inventory amount of such assets under the method provided in section 472,

shall be treated as gain to the corporation recognized from the sale of such inventory assets.

(2) *Definitions.* For purposes of paragraph (1)—

(A) *Inventory assets.* The term "inventory assets" means stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.

(B) *Inventory amount.* The term "inventory amount" means, in the case of inventory assets distributed during a taxable year, the amount of such inventory assets determined as if the taxable year closed at the time of such distribution.

(3) *Method of determining inventory amount.* For purposes of this subsection, the inventory amount of assets under a method authorized by section 471 shall be determined—

(A) If the corporation uses the retail method of valuing inventories under section 472, by using such method, or

(B) If subparagraph (A) does not apply, by using cost or market, whichever is lower.

(c) *Liability in excess of basis.* If—

(1) A corporation distributes property to a shareholder with respect to its stock,

(2) Such property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, and

(3) The amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property,

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. In the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis.

§ 1.311–1 General.

(a) Except as provided in subsections (b) and (c) of section 311 and section 453(d) (relating to installment obligations) no gain or loss is recognized to a corporation on the distribution, with respect to its stock, of stock, or rights to acquire its stock, or property (regardless of the fact that such property may have appreciated or depreciated in value since its acquisition by the corporation). However, the proceeds of the sale of property in form made by a shareholder receiving such property in kind from the corporation may be imputed to the corporation if, in fact, the corporation made the sale. Moreover, where property is distributed by a corporation, which distribution is in effect an anticipatory assignment of income, such income may be taxable to the corporation. The term "distributions with respect to its stock" includes distributions made in redemption of stock (other than distributions in complete or partial liquidations). See, however, paragraph (e) of this section for distributions to which section 311 does not apply. For the rule respecting the taxation of a corporation making a distribution of property in partial or complete liquidation, see section 336.

(b) In any case in which a corporation distributes with respect to its stock assets which have been part of an inventory, the value of which has been computed for income tax purposes under the method provided in section 472 (relating to last-in, first-out inventories), such corporation shall—

(1) Compute the amount of its inventory under the method provided in section 472 immediately prior to the distribution and immediately after such distribution;

(2) Compute the difference between the two amounts described in subparagraph (1) of this paragraph;

(3) Compute the amount of its inventory under the method authorized by section 471 (relating to general rule for inventories) immediately prior to the distribution and immediately after such distribution;

(4) Compute the difference between the two amounts determined under subparagraph (3) of this paragraph.

If the amount computed under subparagraph (4) of this paragraph is in excess of the amount computed under subparagraph (2) of this paragraph, then such excess shall be included in the income of the corporation for the year in which such distribution occurs. In any case in which a corporation distributes assets which have been a part of an inventory whose value has been computed for income tax purposes under the method provided in section 472, such corporation shall on the date of distribution record a specific statement of the amount of its inventory under each of the applicable methods for use in the determination of the amount of income includible under section 311.

(c) The following example illustrates the application of section 311 (b):

Example. Corporation R, a manufacturing corporation inventorying goods under the method provided in section 472, distributes 200 units of its inventory assets to its shareholders on November 15, 1955. Immediately before the distribution, the corporation held 300 identical inventory units at the following basis determined by reference to the value computed by using the LIFO method and the value computed by using the FIFO method, in the order of acquisition:

Number of units	Basis LIFO	Number of units	Basis FIFO
a. 100	$1,000	100	$4,000
b. 100	2,000	50	2,500
c. 50	1,000	50	2,500
d. 50	2,000	100	6,000

The amount includible in income pursuant to section 311 (b) is $4,000 computed as follows:

(1) Inventory before distribution under FIFO method (a, b, c and d)	$15,000
(2) Inventory under FIFO method immediately after distribution (d)	6,000
(3) Difference (FIFO basis of inventory distributed)	$9,000
(4) Inventory before distribution under LIFO method (a, b, c and d)	$6,000
(5) Inventory under LIFO method immediately after distribution (a)	$1,000
(6) Difference (LIFO basis of inventory distributed)	5,000
(7) Amount includible in income under section 311 (b)	4,000

(d) Section 311 (c) provides in general for the inclusion in the income of a corporation, on a distribution of property by such corporation to its shareholders, of an amount equal to the excess of a liability over the basis of the property distributed. Thus, section 311 (c) applies where the property distributed is subject to a liability or where the shareholder assumes a liability of the corporation in connection with the distribution. For example, if property which is a capital asset having an adjusted basis to the distributing corporation of $100 and a fair market value of $1,000 (but subject to a liability of $900) is distributed to a shareholder, such distribution is taxable (as long-term or short-term gain, as the case may be) to the corporation to the extent of the excess of the liability ($900) over the adjusted basis ($100) or $800. However, if in the preceding example the fair market value of the property distributed were $800, the amount taxable to the corporation is limited to the excess of the fair market value of the property ($800) over its adjusted basis ($100) or $700. If the property subject to a liability were not a capital asset in the hands of the distributing corporation, the gain would be taxable as gain from the sale of a noncapital asset. The holding period of assets so distributed shall be determined as if such property were sold on the date of the distribution.

(e) (1) Section 311 is limited to distributions which are made by reason of the corporation-stockholder relationship. Section 311 does not apply to transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee, or vendee, where the fact that such debtor, creditor, employee, or vendee is a shareholder is incidental to the transaction. Thus, if the corporation receives its own stock as consideration upon the sale of property by it or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property.

(2) The following examples illustrate the application of subparagraph (1) of this paragraph:

Example (1). Corporation A has a claim against Corporation B for damages for loss of profits due to patent infringement. Corporation B satisfies such claim by surrendering shares of the stock of Corporation A to Corporation A. The fair market value of such stock is includible in the gross income of Corporation A.

Example (2). Corporation C, a corporation engaged in the manufacture and sale of automobiles, sells an automobile to individual X, and receives in payment therefor shares of the stock of Corporation C. The transaction will be treated in the same manner as if an amount of cash equal to the fair market value of such stock had been received by Corporation C.

§ 1.312 Statutory provisions; effect on earnings and profits.

SEC. 312. *Effect on earnings and profits*—(a) *General rule.* Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) The amount of money,

(2) The principal amount of the obligations of such corporation, and

(3) The adjusted basis of the other property,

so distributed,

(b) *Certain inventory assets*—(1) *In general.* On the distribution by a corporation, with respect to its stock, of inventory assets (as defined in paragraph (2) (A)) the fair market value of which exceeds the adjusted basis thereof, the earnings and profits of the corporation—

(A) Shall be increased by the amount of such excess; and

(B) Shall be decreased by whichever of the following is the lesser:

(i) The fair market value of the inventory assets distributed, or

(ii) The earnings and profits (as increased under subparagraph (A)).

(2) *Definitions*—(A) *Inventory assets.* For purposes of paragraph (1), the term "inventory assets" means—

(i) Stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year;

(ii) Property held by the corporation primarily for sale to customers in the ordinary course of its trade or business; and

(iii) Unrealized receivables or fees, except receivables from sales or exchanges of assets other than assets described in this subparagraph.

(B) *Unrealized receivables or fees.* For purposes of subparagraph (A) (iii), the term "unrealized receivables or fees" means, to the extent not previously includible in income under the method of accounting used by the corporation, any rights (contractual or otherwise) to payment for—

(1) Goods delivered, or to be delivered, to the extent that the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(ii) Services rendered or to be rendered.

(c) *Adjustments for liabilities, etc.* In making the adjustments to the earnings and profits of a corporation under subsection (a) or (b), proper adjustment shall be made for—

(1) The amount of any liability to which the property distributed is subject,

(2) The amount of any liability of the corporation assumed by a shareholder in connection with the distribution, and

(3) Any gain to the corporation recognized under subsection (b) or (c) of section 311.

(d) *Certain distributions of stock and securities*—(1) *In general.* The distribution to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property, in a distribution to which this Code applies, shall not be considered a distribution of the earnings and profits of any corporation—

(A) If no gain to such distributee from the receipt of such stock or securities, or property, was recognized under this Code, or

(B) If the distribution was not subject to tax in the hands of such distributee by reason of section 305 (a).

(2) *Prior distributions.* In the case of a distribution of stock or securities, or property, to which section 115 (h) of the Internal Revenue Code of 1939 (or the corresponding provision of prior law) applied, the effect on earnings and profits of such distribution shall be determined under such section 115 (h), or the corresponding provision of prior law, as the case may be.

(3) *Stock or securities.* For purposes of this subsection, the term "stock or securities" includes rights to acquire stock or securities.

(e) *Special rule for partial liquidations and certain redemptions.* In the case of amounts distributed in partial liquidation (whether before, on, or after June 22, 1954) or in a redemption to which section 302 (a) or 303 applies, the part of such distribution which is properly chargeable to capital account shall not be treated as a distribution of earnings and profits.

(f) *Effect on earnings and profits of gain or loss and of receipt of tax-free distributions*—(1) *Effect on earnings and profits of gain or loss.* The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(A) For the purpose of the computation of the earnings and profits of the corporation, shall (except as provided in subparagraph (B)) be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(B) For purposes of the computation of the earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing taxable income under the law applicable to the year in which such sale or disposition was made. Where, in determining the adjusted basis used in computing such realized gain or loss, the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings and profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For purposes of this subsection, a loss with respect to which a deduction is disallowed under section 1091 (relating to wash sales of stock or securities), or the corresponding provision of prior law, shall not be deemed to be recognized.

(2) *Effect on earnings and profits of receipt of tax-free distributions.* Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(A) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made; and

(B) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received (or such basis would, but for section 307 (b), be so allocated).

(g) *Earnings and profits—increase in value accrued before March 1, 1913.* (1) If any increase or decrease in the earnings and profits for any period beginning after February 28, 1913, with respect to any matter would be different had the adjusted basis of the property involved been determined without regard to its March 1, 1913, value, then, except as provided in paragraph (2), an increase (properly reflecting such difference) shall be made in that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

(2) If the application of subsection (f) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding subsection (f) and in lieu of the rule provided in paragraph (1) of this subsection, the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss exceeds the adjusted basis computed without regard to the value of the property on March 1, 1913, and if such amount so applied in reduction of the decrease exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

(h) *Earnings and profits of personal service corporations.* In the case of a personal service corporation subject for any taxable year to supplement S of the Internal Revenue Code of 1939, an amount equal to the undistributed supplement S net income of the personal service corporation for its taxable year shall be considered as paid in as of the close of such taxable year as paid-in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of such taxable year shall be correspondingly reduced, if such amount or any portion thereof is required to be included as a dividend in the gross income of the shareholders.

(i) *Allocation in certain corporate separations.* In the case of a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation (or corporations) shall be made under regulations prescribed by the Secretary or his delegate.

(j) *Distribution of proceeds of loan insured by the United States*—(1) *In general.* If a corporation distributes property with respect to its stock, and if, at the time of the distribution—

(A) There is outstanding a loan to such corporation which was made, guaranteed, or insured by the United States (or by any agency or instrumentality thereof), and

(B) The amount of such loan so outstanding exceeds the adjusted basis of the property constituting security for such loan,

then the earnings and profits of the corporation shall be increased by the amount of such excess and (immediately after the distribution) shall be decreased by the amount of such excess. For purposes of subparagraph (B) of the preceding sentence, the adjusted basis of the property at the time of distribution shall be determined without regard to any adjustment under section 1016 (a) (2) (relating to adjustment for depreciation, etc.). For purposes of this paragraph, a commitment to make, guarantee, or insure a loan shall be treated as the making, guaranteeing, or insuring of a loan.

(2) *Effective date.* Paragraph (1) shall apply only with respect to distributions made on or after June 22, 1954.

§ 1.312–1 Adjustment to earnings and profits reflecting distributions by corporations.

(a) In general, on the distribution of property by a corporation with respect to its stock, its earnings and profits (to the extent thereof) shall be decreased by—

(1) The amount of money,

(2) The principal amount of the obligations of such corporation issued in such distribution, and

(3) The adjusted basis of other property.

For special rule with respect to distributions to which section 312 (e) applies, see § 1.312–5.

(b) The adjustment provided in section 312(a)(3) and paragraph (a)(3) of this section with respect to a distribution of property (other than money or its own obligations) shall be made notwithstanding the fact that such property has appreciated or depreciated in value since acquisition.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Corporation A distributes to its sole shareholder property with a value of $10,000 and a basis of $5,000. It has $12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is $5,000. Such is the reduction even though the amount of $10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.

Example (2). The facts are the same as in example (1) above except that the property has a basis of $15,000 and the earnings and profits of the corporation are $20,000. The reduction in earnings and profits is $15,000. Such is the reduction even though only the amount of $10,000 is includible in the income of the shareholder as a dividend.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305 (b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§ 1.312–2 Distribution of inventory assets.

Section 312(b) provides for the increase and the decrease of the earnings and profits of a corporation which distributes, with respect to its stock, inventory assets as defined in section 312 (b) (2), where the fair market value of such assets exceeds their adjusted basis. The rules provided in section 312 (b) (relating to distributions of certain inventory assets) shall be applicable without regard to the method used in computing inventories for the purpose of the computation of taxable income. Section 312 (b) does not apply to distributions described in section 312 (e).

§ 1.312–3 Liabilities.

The amount of any reductions in earnings and profits described in section 312 (a) or (b) shall be (a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and (b) increased by the amount of gain recognized to the corporation under section 311 (b) or (c).

§ 1.312–4 Examples of adjustments provided in section 312(c).

The adjustments provided in section 312(c) may be illustrated by the following examples:

Example (1). On December 2, 1954, Corporation X distributed to its sole shareholder, A, an individual, as a dividend in kind a vacant lot which was not an inventory asset. On that date, the lot had a fair market value of $5,000 and was subject to a mortgage of $2,000. The adjusted basis of the lot was $3,100. The amount of the earnings and profits was $10,000. The amount of the dividend received by A is $5,000, and there is no reduction in the earnings and profits of the corporation as a result of the distribution (disregarding such reduction as may result from an increase in tax to Corporation X because of gain resulting from the distribution). There is a gain of $1,900 recognized to Corporation X, the difference between the basis of the property ($3,100) and the amount of the mortgage ($2,000), under section 311 (c) and an increase in earnings and profits of $1,900.

Example (2). The facts are the same as in example (1) above with the exception that the amount of the mortgage to which the property was subject was $4,000. The amount of the dividend received by A is $1,000, and there is no reduction in the earnings and profits of the corporation as a result of the distribution (disregarding such reduction as may result from an increase in tax to Corporation X because of gain resulting from the distribution). There is a gain of $900 recognized to Corporation X, the difference between the basis of the property ($3,100) and the amount of the mortgage ($4,000), under section 311 (c) and an increase in earnings and profits of $900.

Example (3). Corporation A, having accumulated earnings and profits of $100,000, distributed in kind to its shareholders, not in liquidation, inventory assets which had a basis to it on the "Lifo" method (section 472) of $46,000 and on the basis of cost or market (section 471) of $50,000. The inventory had a fair market value of $55,000 and was subject to a liability of $35,000. This distribution results in a net decrease in earnings and profits of Corporation A of $11,000, (without regard to any tax on Corporation A) computed as follows:

"Fifo" basis of inventory	$50,000	
Less: "Lifo" basis of inventory	46,000	
Gain recognized—addition to earnings and profits (section 311 (b))		$4,000
Adjustment to earnings and profits required by section 312 (b) (1) (A):		
Fair market value of inventory	$55,000	
Less: "Lifo" basis plus adjustment under section 311 (b)	50,000	5,000
Total increase in earnings and profits		9,000
Decrease in earnings and profits—under section 312 (b) (1) (B) (i)	$55,000	
Less: Liability assumed	35,000	
Net amount of distribution (decrease in earnings)		20,000
Net decrease in earnings and profits		11,000

§ 1.312–5 Special rule for partial liquidations and certain redemptions.

The part of the distribution properly chargeable to capital account within the provisions of section 312 (e) shall not be considered a distribution of earnings and profits within the meaning of section 301 for the purpose of determining taxability of subsequent distributions by the corporation.

§ 1.312–6 Earnings and profits.

(a) In determining the amount of earnings and profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated before March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income (or net income, as the case may be). For instance, a corporation keeping its books and filing its income tax returns under subchapter E, chapter 1 of the Code, on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 453 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 831 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 832 (b) (4) and which is segregated accordingly in the unearned premium reserve.

(b) Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts. Gains and losses within the purview of section 1002 or corresponding provisions of prior revenue acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

(c) (1) In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (i) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (ii) adjusted cost or March 1, 1913, value, whichever is higher, if acquired before March 1, 1913. Thus, discovery or percentage depletion under all revenue acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Oil producing property which A had acquired in 1949 at a cost of $28,000 was transferred to Corporation Y in December 1951, in exchange for all of its capital stock. The fair market value of the stock and of the property as of the date of the transfer was $247,000. Corporation Y, after four years' operation, effected in 1955 a cash distribution to A in the amount of $165,000. In determining the extent to which the earnings and profits of Corporation Y available for dividend distributions have been increased as the result of production and sale of oil, the depletion to be taken into account is to be computed upon the basis of $28,000 established in the nontaxable exchange in 1951 regardless of the fair market value of the property or of the stock issued in exchange therefor.

(d) A loss sustained for a year before the taxable year does not affect the earnings and profits of the taxable year. However, in determining the earnings and profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings and profits accumulated since February 28, 1913, and before the year for which the

loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. If the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings and profits accumulated since the year of the loss to the extent of such earnings.

(e) With respect to the effect on the earnings and profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and before August 6, 1917, out of earnings or profits accumulated before March 1, 1913, which distributions were specifically declared to be out of earnings and profits accumulated before March 1, 1913, see section 31 (b) of the Revenue Act of 1916, as added by section 1211 of the Revenue Act of 1917 (40 Stat. 336).

§ 1.312–7 Effect on earnings and profits of gain or loss realized after February 28, 1913.

(a) In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 312(f)(1) prescribed certain rules for—

(1) The computation of the total earnings and profits of the corporation of most frequent application in determining invested capital; and

(2) The computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions.

Such rules are applicable whenever under any provision of subtitle A of the Code it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the regulations prescribed by this section for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under subparagraph (1) of this paragraph, such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under subparagraph (2) of this paragraph, there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see § 1.312–6). Under both subparagraphs (1) and (2) of this paragraph, the adjusted basis is subject to the limitations of the third sentence of section 312 (f) (1) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under section 312 (f)(1) (A) and (B) depending upon the basis to which the adjustments are to be made. If the application of section 312 (f)(1)(B) results in a loss and if the application of section 312(f)(1)(A) to the same transaction reaches a different result, then the loss under section 312(f)(1)(B) will be subject to the adjustment thereto required by section 312(g)(2). (See § 1.312–9.)

(b) (1) The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing taxable income (or net income, as the case may be) under the law applicable to the year in which such sale or disposition was made. As used in this paragraph, the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized. For example, see section 356. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 1091 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 267 and 1211 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 1091 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 312 (f) (1) as distinguished from the realized gain or loss used in computing taxable income (or net income, as the case may be).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Corporation X on January 1, 1952, owned stock in Corporation Y which it had acquired from Corporation Y in December 1951, in an exchange transaction in which no gain or loss was recognized. The adjusted basis to Corporation X of the property exchanged by it for the stock in Corporation Y was $30,000. The fair market value of the stock in Corporation Y when received by Corporation X was $930,000. On April 9, 1955, Corporation X made a cash distribution of $900,000 and, except for the possible effect of the transaction in 1951, had no earnings or profits accumulated after February 28, 1913, and had no earnings or profits for the taxable year. The amount of $900,000 representing the excess of the fair market value of the stock of Corporation Y over the adjusted basis of the property exchanged therefor was not recognized gain to Corporation X under the provisions of section 112 of the Internal Revenue Code of 1939. Accordingly, the earnings and profits of Corporation X are not increased by $900,000, the amount of the gain realized but not recognized in the exchange, and the distribution was not a taxable dividend. The basis in the hands of Corporation Y of the property acquired by it from Corporation X is $30,000. If such property is thereafter sold by Corporation Y, gain or loss will be computed on such basis of $30,000, and earnings and profits will be increased or decreased accordingly.

Example (2). On January 2, 1910, Corporation M acquired nondepreciable property at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of Corporation M was $2,200. On December 31, 1952, Corporation M transfers such property to Corporation N in exchange for $1,900 in cash and all Corporation N's stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of Corporation M, the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March 1, 1913, value), $1,900 of which is recognized under section 356, since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by $1,900. In computing the earnings and profits of Corporation M for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112 (c) of the Internal Revenue Code of 1939, the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after March 1, 1913, see § 1.312–9.

Example (3). On July 31, 1955, Corporation R owned oil-producing property acquired after February 28, 1913, at a cost of $200,000, but having an adjusted basis (by reason of taking percentage depletion) of $100,000 for determining gain. However, the adjusted basis of such property to be used in computing gain or loss for the purpose of earnings and profits is, because of the provisions of the third sentence of section 312 (f) (1), $150,000. On such day Corporation R transferred such property to Corporation S in exchange for $25,000 in cash and all of the stock of Corporation S, which had a fair market value of $100,000. For the purpose of computing taxable income, Corporation R has realized a gain of $25,000 as a result of this transaction, all of which is recognized under section 356. For the purpose of computing earnings and profits, however, Corporation R has realized a loss of $25,000, none of which is recognized owing to the provisions of section 356 (c). The earnings and profits of Corporation R are therefore neither increased nor decreased as a result of the transaction. The adjusted basis of the Corporation S stock in the hands of Corporation R for purposes of computing earnings and profits, however, will be $125,000 (though only $100,000 for the purpose of computing taxable income), computed as follows:

Basis of property transferred	$200,000
Less money received on exchange	25,000
Plus gain or minus loss recognized on exchange	None
Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred)	50,000
Adjusted basis of stock	125,000

If, therefore, Corporation R should subsequently sell the Corporation S stock for $100,000, a loss of $25,000 will again be realized for the purpose of computing earnings and profits, all of which will be recognized and will be applied to decrease the earnings and profits of Corporation R.

(c) (1) The third sentence of section 312 (f) (1) provides for cases in which the adjustments, prescribed in section 1016, to the basis indicated in section 312(f)(1) (A) or (B), as the case may be, differ from the adjustments to such basis proper for the purpose of determining earnings or profits. The adjustments provided by such third sentence reflect the treatment provided by § 1.312–6 relative to cases where the deductions for depletion and depreciation in computing taxable income (or net income, as the case may be) differ from the deductions proper for the purpose of computing earnings and profits.

(2) The effect of the third sentence of section 312 (f) (1) may be illustrated by the following examples:

Example (1). Corporation X purchased on January 2, 1931, an oil lease at a cost of $10,000. The lease was operated only for the years 1931 and 1932. The deduction for depletion in each of the years 1931 and 1932 amounted to $2,750, of which amount $1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1955 for $15,000. Under section 1016 (a) (2), in determining the gain or loss from the sale of the property, the basis must be adjusted for cost depletion of $1,000 in 1931 and percentage depletion of $2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is $1,000 for each year, or $2,000. Hence, the cost is to be adjusted only to the extent of $2,000, leaving an adjusted basis of $8,000 and the earnings and profits will be increased by $7,000, and not by $8,750. The difference of $1,750 is equal to the amount by which the percentage depletion for the year 1932 ($2,750) exceeds the depletion on cost for that year ($1,000) and has already been applied in the computation of earnings and profits for the year 1932 by taking into account only $1,000 instead of $2,750 for depletion in the computation of such earnings and profits. (See § 1.316–1.)

Example (2). If, in example (1), above, the property, instead of being sold, is exchanged in a transaction described in section 1031 for like property having a fair market value of $7,750 and cash of $7,250, then the increase in earnings and profits amounts to $7,000, that is, $15,000 ($7,750 plus $7,250) minus the basis of $8,000. However, in computing taxable income of Corporation X, the gain is $8,750, that is, $15,000 minus $6,250 ($10,000 less depletion of $3,750), of which only $7,250 is recognized because the recognized gain cannot exceed the sum of money received in the transaction. See section 1031 (b) and the corresponding provisions of prior revenue laws. If, however, the cash received was only $2,250 and the value of the property received was $12,750, then the increase in earnings and profits would be $2,250, that amount being the gain recognized under section 1031.

(d) For adjustment and allocation of the earnings and profits of the transferor as between the transferor and the transferee in cases where the transfer of property by one corporation to another corporation results in the nonrecognition in whole or in part of gain or loss, see § 1.312–10; and see section 381 for earnings and profits of successor corporations in certain transactions.

§ 1.312–8 Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.

(a) In order to determine the effect on earnings and profits, where a corporation receives (after February 28, 1913) from a second corporation a distribution which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, section 312(f) prescribes certain rules. It provides that the amount of such distribution shall not increase the earnings and profits of the first or receiving corporation in the following cases: (1) No such increase shall be made in respect of the part of such distribution which (under the law applicable to the year in which the distribution was made) is directly applied in reduction of the basis of the stock in respect of which the distribution was made and (2) no such increase shall be made if (under the law applicable to the year in which the distribution was made) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received (or such basis would but for section 307(b) be so allocated). Where, therefore, the law (applicable to the year in which the distribution was made, as, for example, a distribution in 1934 from earnings and profits accumulated before March 1, 1913) requires that the amount of such distribution shall be applied against and reduce the basis of the stock with respect to which the distribution was made, there is no increase in the earnings and profits by reason of the receipt of such distribution. Similarly, where there is received by a corporation a distribution from another corporation in the form of a stock dividend and the law applicable to the year in which such distribution was made requires the allocation, as between the old stock and the stock received as a dividend, of the basis of the old stock (or such basis would but for section 307(b) be so allocated), then there is no increase in the earnings and profits by reason of the receipt of such stock dividend even though such stock dividend constitutes income within the meaning of the sixteenth amendment to the Constitution.

(b) The principles set forth in paragraph (a) of this section may be illustrated by the following examples:

Example (1). Corporation X in 1955 distributed to Corporation Y, one of its shareholders, $10,000 which was out of earnings or profits accumulated before March 1, 1913, and did not exceed the adjusted basis of the stock in respect of which the distribution was made. This amount of $10,000 was, therefore, a tax-free distribution and under the provisions of section 301 (c) (2) must be applied against and reduce the adjusted basis of the stock in respect of which the distribution was made. The earnings and profits of Corporation Y are not increased by reason of the receipt of this distribution.

Example (2). Corporation Z in 1955 had outstanding common and preferred stock of which Corporation Y held 100 shares of the common and no preferred. The stock had a cost basis to Corporation Y of $100 per share, or a total cost of $10,000. In December of that year it received a dividend of 100 shares of the preferred stock of Corporation Z. Such distribution is a stock dividend which, under section 305, was not taxable and was accordingly not included in the gross income of Corporation Y. The original cost of $10,000 is allocated to the 200 shares of Corporation Z none of which has been sold or otherwise disposed of by Corporation Y. See section 307 and § 1.307–1. The earnings and profits of Corporation Y are not increased by reason of the receipt of such stock dividend.

§ 1.312–9 Adjustments to earnings and profits reflecting increase in value accrued before March 1, 1913.

(a) In order to determine, for the purpose of ascertaining the source of dividend distributions, that part of the earnings and profits which is represented by increase in value of property accrued before, but realized on or after, March 1, 1913, section 312(g) prescribes certain rules.

(b) (1) Section 312 (g) (1) sets forth the general rule with respect to computing the increase to be made in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

(2) The effect of section 312 (g) (1) may be illustrated by the following examples:

Example (1). Corporation X acquired nondepreciable property before March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000 and it was sold in 1955 for $15,000. The increase in earnings and profits based on the value as of March 1, 1913, representing earnings and profits accumulated since February 28, 1913, is $3,000. If the basis is determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of $5,000. The difference of $2,000 ($5,000 minus $3,000) represents the increase to be made in that part of the earnings and profits of Corporation X consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

Example (2). Corporation Y acquired depreciable property in 1908 at a cost of $100,000. Assuming no additions or betterments, and that the depreciation sustained before March 1, 1913, was $10,000, the adjusted cost as of that date was $90,000. Its fair market value as of March 1, 1913, was $94,000 and on February 28, 1955, it was sold for $25,000. For the purpose of determining gain from the sale, the basis of the property is the fair market value of $94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If the amount of the depreciation deduction allowed after February 28, 1913, and properly allowable for each of such years to the date of the sale in 1955 is the aggregate sum of $81,467, the adjusted basis for determining gain in 1955 ($94,000 less $81,467) is $12,533 and the gain would be $12,467 ($25,000 less $12,533). The increase in earnings and profits accumulated since February 28, 1913, by reason of the sale, based on the value as of March 1, 1913, adjusted for depreciation is $12,467. If the depreciation since February 28, 1913, had been based on the adjusted cost of $90,000 ($100,000 less $10,000) instead of the March 1, 1913, value of $94,000, the depreciation sustained from that date to the date of sale would have been $78,000 instead of $81,467 and the actual gain on the sale based on the cost of $100,000 adjusted by depreciation on such cost to $12,000 ($100,000 reduced by the sum of $10,000 and $78,000) would be $13,000 ($25,000 less $12,000). If the adjusted basis of the property was determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits

of $13,000. The difference of $533 ($13,000 minus $12,467) represents the increase to be made in that part of the earnings and profits of Corporation Y consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913 (assuming that the proper increase in such surplus had been made each year for the difference between depreciation based on cost and the depreciation based on March 1, 1913, value). Thus, the total increase in that part of earnings and profits consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913, is $4,000 ($94,000 less $90,000).

(c) (1) Section 312 (g) (2) is an exception to the general rule in section 312 (g) (1) and also operates as a limitation on the application of section 312 (f). It provides that, if the application of section 312(f)(1)(B) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding section 312(f) and in lieu of the rule provided in section 312(g)(1), the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the fair market value of the property on March 1, 1913. If the amount so applied in reduction of the loss exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after March 1, 1913.

(2) The application of section 312 (g) (2) may be illustrated by the following examples:

Example (1). Corporation Y acquired nondepreciable property before March 1, 1913, at a cost of $8,000. Its fair market value as of March 1, 1913, was $13,000, and it was sold in 1955 for $10,000. Under section 312(f)(1)(B) the adjusted basis would be $13,000 and there would be a loss of $3,000. The application of section 312(f)(1)(B) would result in a loss from the sale in 1955 to be applied in decrease of earnings and profits for that year. Section 312(g)(2), however, applies and the loss of $3,000 is reduced by the amount by which the adjusted basis of $13,000 exceeds the cost of $8,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely $5,000. The amount of the loss is, accordingly, reduced from $3,000 to zero and there is no decrease in earnings and profits of Corporation Y for the year 1955 as a result of the sale. The amount applied in reduction of the decrease, namely, $5,000, exceeds $3,000. Accordingly, as a result of the sale the excess of $2,000 increases that part of the earnings and profits of Corporation Y consisting of increase in value of property accrued before, but realized on or after March 1, 1913.

Example (2). Corporation Z acquired nondepreciable property before March 1, 1913, at a cost of $10,000. Its fair market value as of March 1, 1913, was $12,000, and it was sold in 1955 for $8,000. Under section 312(f)(1)(B) the adjusted basis would be $12,000 and there would be a loss of $4,000. The application of section 312(f)(1)(B) would result in a loss from the sale in 1955 to be applied in decrease of earnings and profits for that year. Section 312 (g) (2), however, applies and the loss of $4,000 is reduced by the amount by which the adjusted basis of $12,000 exceeds the cost of $10,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, $2,000. The amount of the loss is, accordingly, reduced from $4,000 to $2,000 and the decrease in earnings and profits of Corporation Z for the year 1955 as a result of the sale is $2,000 instead of $4,000. The amount applied in reduction of the decrease, namely, $2,000, does not exceed $4,000. Accordingly, as a result of the sale there is no increase in that part of the earnings and profits of Corporation Z consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

§ 1.312–10 Allocation of earnings in certain corporate separations.

(a) If one corporation transfers part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the earnings and profits of the distributing corporation immediately before the transaction shall be allocated between the distributing corporation and the controlled corporation. In the case of a newly created controlled corporation, such allocation generally shall be made in proportion to the fair market value of the business or businesses (and interests in any other properties) retained by the distributing corporation and the business or businesses (and interests in any other properties) of the controlled corporation immediately after the transaction. In a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case. The term "net basis" means the basis of the assets less liabilities assumed or liabilities to which such assets are subject. The part of the earnings and profits of the taxable year of the distributing corporation in which the transaction occurs allocable to the controlled corporation shall be included in the computation of the earnings and profits of the first taxable year of the controlled corporation ending after the date of the transaction.

(b) If a distribution or exchange to which section 355 applies (or so much of section 356 as relates to section 355) is not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368 (a) (1) (D), the earnings and profits of the distributing corporation shall be decreased by the lesser of the following amounts:

(1) The amount by which the earnings and profits of the distributing corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a reorganization to which section 368 (a) (1) (D) applied and immediately thereafter distributed the stock of such new corporation or,

(2) The net worth of the controlled corporation. (For this purpose the term "net worth" means the sum of the bases of all of the properties plus cash minus all liabilities.)

If the earnings and profits of the controlled corporation immediately before the transaction are less than the amount of the decrease in earnings and profits of the distributing corporation (including a case in which the controlled corporation has a deficit) the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of such decrease. If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in the earnings and profits of the distributing corporation, they shall remain unchanged.

(c) In no case shall any part of a deficit of a distributing corporation within the meaning of section 355 be allocated to a controlled corporation.

§ 1.312–11 Effect on earnings and profits of certain other tax-free exchanges, tax-free distributions, and tax-free transfers from one corporation to another.

(a) If property is transferred by one corporation to another, and, under the law applicable to the year in which the transfer was made, no gain or loss was recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings and profits of the transferor shall be made as between the transferor and the transferee. Transfers to which the preceding sentence applies include contributions to capital, transfers under section 351, transfers in connection with reorganizations under section 368, transfers in liquidations under section 332 and intercompany transfers during a period of affiliation. However, if, for example, property is transferred from one corporation to another in a transaction under section 351 or as a contribution to capital and the transfer is not followed or preceded by a reorganization, a transaction under section 302 (a) involving a substantial part of the transferor's stock, or a total or partial liquidation, then ordinarily no allocation of the earnings and profits of the transferor shall be made. For specific rules as to allocation of earnings and profits in certain reorganizations under section 368 and in certain liquidations under section 332 see section 381 and the regulations thereunder. For allocation of earnings and profits in certain corporate separations see section 312(i) and § 1.312–10.

(b) The general rule provided in section 316 that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, or in a transaction subject to section 355, to its shareholders—

(i) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corpo-

ration (see section 112 (g) of the Revenue Act of 1932 (47 Stat. 197)); or

(ii) Of stock (other than preferred stock) in another corporation which is a party to the reorganization without the surrender by the distributees of stock in the distributing corporation if the distribution occurs after October 20, 1951, and is subject to section 112 (b) (11) of the Internal Revenue Code of 1939; or

(iii) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1, 1939, or on or after such date, in exchange for its stock or securities in a transaction to which section 112 (b) (3) of the Internal Revenue Code of 1939 was applicable; or

(iv) Of stock or securities in such corporation or in another corporation in exchange for its stock or securities in a transaction subject to section 354 or 355,

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1936 (49 Stat. 1679), the Revenue Act of 1938 (52 Stat. 485), of the Internal Revenue Code of 1939, or section 332 of the Internal Revenue Code of 1954.

(3) The distribution in any taxable year (beginning after December 31, 1938), of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 of the Internal Revenue Code of 1939 or in section 1081 of the Internal Revenue Code of 1954 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributee from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 (48 Stat. 712) or a corresponding provision of a prior Revenue Act, or section 305 of the Code.

(5) The distribution, in a taxable year of the distributee beginning after December 31, 1931, by or on behalf of an insolvent corporation, in connection with a section 112 (b) (10) reorganization under the Internal Revenue Code of 1939, or in a transaction subject to section 371 of the Internal Revenue Code of 1954, of stock or securities in a corporation organized or made use of to effectuate the plan of reorganization, if under section 112(l) of the Internal Revenue Code of 1939 or section 371 of the Internal Revenue Code of 1954 no gain to the distributee from the receipt of such stock or securities was recognized by law.

(c) A distribution described in paragraph (b) of this section does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (b) (1), (2), (3), or (5) of this section) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

(d) For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932 (47 Stat. 196); for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934 (48 Stat. 704); for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936 (49 Stat. 1678); for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938 (52 Stat. 485); and for any taxable year beginning after December 31, 1938, and ending before June 22, 1954, providing no election is made under sec-393(b)(2) of the Internal Revenue Code of 1954, have the meanings assigned to such terms in section 112(g)(1) of the Internal Revenue Code of 1939.

§ 1.312–12 Distributions of proceeds of loans guaranteed by the United States.

(a) The provisions of section 312(j) are applicable with respect to a loan, any portion of which is guaranteed by an agency of the United States Government without regard to the percentage of such loan subject to such guarantee.

(b) The application of section 312 (j) is illustrated by the following example:

Example. Corporation A borrowed $1,000,000 for the purpose of construction of an apartment house, the cost and adjusted basis of which was $900,000. This loan was guaranteed by an agency of the United States Government. One year after such loan was made and after the completion of construction of the building (but before such corporation had received any income) it distributed $100,000 cash to its shareholders. The earnings and profits of the taxable year of such corporation are increased (pursuant to section 312 (j)) by $100,000 immediately prior to such distribution and are decreased by $100,000 immediately after such distribution. Such decrease, however, does not reduce the earnings and profits below zero. Two years later, it has no accumulated earnings and has earnings of the taxable year of $100,000. Before it has made any payments on the loan, it distributes $200,000 to its shareholders. The earnings and profits of the taxable year of the corporation ($100,000) are increased by $100,000, the excess of the amount of the guaranteed loan over the adjusted basis of the apartment house (calculated without adjustment for depreciation). The entire amount of each distribution is treated as a distribution out of earnings and profits and, accordingly, as a taxable dividend.

DEFINITIONS; CONSTRUCTIVE OWNERSHIP OF STOCK

§ 1.316 Statutory provisions; dividend defined.

SEC. 316. *Dividend Defined*—(a) *General rule.* For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) Out of its earnings and profits accumulated after February 28, 1913, or

(2) Out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) *Special rules*—(1) *Certain insurance company dividends.* The definition in subsection (a) shall not apply to the term "dividend" as used in sections 803 (c), 821 (a) (2), 823 (2), and 832 (c) (11) (where the reference is to dividends of insurance companies paid to policyholders.)

(2) *Distributions by personal holding companies.* In the case of a corporation which—

(A) Under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(B) For the taxable year in respect of which the distribution is made under section 563 (b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

§ 1.316–1 Dividends.

(a)(1) The term "dividend" for the purpose of subtitle A of the Code (except when used in section 803(e), section 821 (a)(2), section 823(2), and section 832 (c)(11) where the reference is to dividends of insurance companies paid to policyholders) comprises any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount, made

by a domestic or foreign corporation to its shareholders out of either—

(i) Earnings and profits accumulated since February 28, 1913, or

(ii) Earnings and profits of the taxable year computed without regard to the amount of the earnings and profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings and profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

(2) Where a corporation distributes property to its shareholders on or after June 22, 1954, the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation.

(3) The rule of (2) above may be illustrated by the following example:

Example. X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of $10,000. Corporation A distributes property having a basis of $6,000 and a fair market value of $16,000 to its shareholders, each shareholder receiving property with a basis of $3,000 and with a fair market value of $8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301 (c) is $5,000.

(b) In the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company or which, for the taxable year in respect of which a distribution is made under section 563 (relating to dividends paid within 2½ months after the close of the taxable year), or section 547 (relating to deficiency dividends), or corresponding provisions of a prior income-tax law, was under the applicable law a personal holding company, the term "dividend" in addition to the meaning set forth in the first sentence of section 316, also means a distribution to its shareholders as follows: A distribution within a taxable year of the corporation, or of a shareholder, is a dividend to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to distributions under section 316 (b) (2)) for the taxable year in which, or, in the case of a distribution under section 563 or section 547, the taxable year in respect of which, the distribution was made.

(c) Except as provided in section 316 (b) (1), the term "dividend" includes any distribution of property to shareholders to the extent made out of accumulated or current earnings and profits. See, however, section 331 (relating to distributions in complete or partial liquidation), section 301 (e) (relating to distributions by personal service corporations), section 302 (b) (relating to redemptions treated as amounts received from the sale or exchange of stock), and section 303 (relating to distributions in redemption of stock to pay death taxes). See also section 305 (b) for certain distributions of stock or stock rights treated as distributions of property.

(d) The application of section 316 may be illustrated by the following examples:

Example (1). At the beginning of the calendar year 1955, Corporation M had an operating deficit of $200,000 and the earnings and profits for the year amounted to $100,000. Beginning on March 16, 1955, the corporation made quarterly distributions of $25,000 during the taxable year to its shareholders. Each distribution is a taxable dividend in full, irrespective of the actual or the pro rata amount of the earnings and profits on hand at any of the dates of distribution, since the total distributions made during the year ($100,000) did not exceed the total earnings and profits of the year ($100,000).

Example (2). At the beginning of the calendar year 1955, Corporation N, a personal holding company, had no accumulated earnings and profits. During that year it made no earnings and profits but, due to the disallowance of certain deductions, its undistributed personal holding company income (determined under section 545 without regard to distributions under section 316 (b) (2)) was $16,000. It distributed to shareholders on December 15, 1955, $15,000, and on February 1, 1956, $1,000, the latter amount being claimed as a deduction under section 563 in its personal holding company schedule for 1955 filed with its return for 1955 on March 15, 1956. Both distributions are taxable dividends in full, since they do not exceed the undistributed personal holding company income (determined without regard to such distributions) for 1955, the taxable year in which the distribution of $15,000 was made and with respect to which the distribution of $1,000 was made. It is immaterial whether Corporation N is a personal holding company for the taxable year 1956 or whether it had any income for that year.

Example (3). In 1959, a deficiency in personal holding company tax was established against Corporation O for the taxable year 1955 in the amount of $35,500 based on an undistributed personal holding company income of $42,000. Corporation O complied with the provisions of section 547 and in December 1959 distributed $42,000 to its stockholders as "deficiency dividends." The distribution of $42,000 is a taxable dividend since it does not exceed $42,000 (the undistributed personal holding company income for 1955, the taxable year with respect to which the distribution was made). It is immaterial whether Corporation O is a personal holding company for the taxable year 1959 or whether it had any income for that year.

Example (4). At the beginning of the taxable year 1955, Corporation P, a personal holding company, had a deficit in earnings and profits of $200,000. During that year it made earnings and profits of $90,000. For that year, however, it had an undistributed personal holding income (determined under section 545 without regard to distributions under section 316 (b) (2)) of $80,000. During such taxable year it distributed to its shareholders $100,000. The distribution of $100,000 is a taxable dividend to the extent of $90,000 since its earnings and profits for that year, $90,000, exceed $80,000, the undistributed personal holding company income determined without regard to such distribution.

§ 1.316–2 Sources of distribution in general.

(a) For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. In determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year; third, to the earnings and profits accumulated before March 1, 1913, only after all the earnings and profits of the taxable year and all the earnings and profits accumulated since February 28, 1913, have been distributed; and, fourth, to sources other than earnings and profits only after the earnings and profits have been distributed.

(b) If the earnings and profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings and profits at the time of the distribution) are sufficient in amount to cover all the distributions made during that year, then each distribution is a taxable dividend. See § 1.316–1. If the distributions made during the taxable year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution which the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year. The portion of each such distribution which is not regarded as out of earnings and profits of the taxable year shall be considered a taxable dividend to the extent of the earnings and profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

(c) The provisions of the section may be illustrated by the following example:

Example. At the beginning of the calendar year 1955, Corporation M had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1955 amounted to $30,000. During the year it made quarterly cash distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and

of the first and second distributions, $7,500 and $4,500. respectively, were paid out of the earnings and profits accumulated after February 28, 1913, and before the taxable year, as follows:

Distributions during 1955		Portion out of earnings and profits of the taxable year	Portion out of earnings accumulated since Feb. 28, 1913, and before the taxable year	Taxable amount of each distribution
Date	Amount			
March 10	$15,000	$7,500	$7,500	$15,000
June 10	15,000	7,500	4,500	12,000
September 10	15,000	7,500		7,500
December 10	15,000	7,500		7,500
Total amount taxable as dividends				42,000

(d) Any distribution by a corporation out of earnings and profits accumulated before March 1, 1913, or out of increase in value of property accrued before March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether before, on, or after March 1, 1913), is not a dividend within the meaning of subtitle A of the Code.

(e) A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or a depreciation reserve based upon the cost or other basis of the property will not be considered as having been paid out of earnings and profits, but the amount thereof shall be applied against and reduce the cost or other basis of the stock upon which declared. If such a distribution is in excess of the basis, the excess shall be taxed as a gain from the sale or other disposition of property as provided in section 301 (c) (3) (A). A distribution from a depletion reserve based upon discovery value to the extent that such reserve represents the excess of the discovery value over the cost or other basis for determining gain or loss, is, when received by the shareholders, taxable as an ordinary dividend. The amount by which a corporation's percentage depletion allowance for any year exceeds depletion sustained on cost or other basis, that is, determined without regard to discovery or percentage depletion allowances for the year of distribution or prior years, constitutes a part of the corporation's "earnings and profits accumulated after February 28, 1913," within the meaning of section 316, and, upon distribution to shareholders, is taxable to them as a dividend. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings and profits, but the amount of the distribution shall be applied against and reduce the cost or other basis of the stock upon which declared. See section 301. No distribution, however, can be made from such a reserve until all the earnings and profits of the corporation have first been distributed.

§ 1.317 Statutory provisions; other definitions.

SEC. 317. *Other definitions*—(a) *Property.* For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption of stock.* For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

§ 1.317–1 Property defined.

The term "property", for purposes of part 1, subchapter C, chapter 1 of the Code, means any property (including money, securities, and indebtedness to the corporation) other than stock, or rights to acquire stock, in the corporation making the distribution.

§ 1.318 Statutory provisions; constructive ownership of stock.

SEC. 318. *Constructive ownership of stock*—(a) *General rule.* For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) *Members of family*—(A) *In general.* An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) His spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) His children, grandchildren and parents.

(B) *Effect of adoption.* For purposes of subparagraph (A) (ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) *Partnerships, estates, trusts and corporations*—(A) *Partnerships and estates.* Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.

(B) *Trusts.* Stock owned, directly or indirectly, by or for a trust shall be considered as being owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. Stock owned, directly or indirectly, by or for a beneficiary of a trust shall be considered as being owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of the preceding sentence, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property. Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E, Part I, subchapter J, of the Code (relating to grantors and others treated as substantial owners) shall be considered as being owned by such person; and such trust shall be treated as owning the stock owned, directly or indirectly, by or for that person. This subparagraph shall not apply with respect to any employees' trust described in section 401 (a) which is exempt from tax under section 501 (a).

(C) *Corporations.* If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

(i) Such person shall be considered as owning the stock owned, directly or indirectly, by or for that corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation; and

(ii) Such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

(3) *Options.* If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) *Constructive ownership as actual ownership*—(A) *In general.* Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3), be treated as actually owned by such person.

(B) *Members of family.* Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be treated as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

(C) *Option rule in lieu of family rule.* For purposes of this paragraph, if stock may be considered as owned by an individual under paragraph (1) or (3), it shall be considered as owned by him under paragraph (3).

(b) *Cross references.* For provisions to which the rules contained in subsection (a) apply, see—

(1) Section 302 (relating to redemption of stock);

(2) Section 304 (relating to redemption by related corporations);

(3) Section 306 (b) (1) (A) (relating to disposition of section 306 stock);

(4) Section 334 (b) (3) (C) (relating to basis of property received in certain liquidations of subsidiaries); and

(5) Section 382 (a) (3) (relating to special limitations on net operating loss carryovers).

§ 1.318–1 Constructive ownership of stock; introduction.

(a) For the purposes of certain provisions of subchapter C, chapter 1 of the Code, section 318(a) provides that stock owned by a taxpayer includes stock constructively owned by such taxpayer under the rules set forth in such section. An individual is considered to own the stock owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and by or for his children, grandchildren, and parents. Under section 318(a)(2), constructive ownership rules are established for partnerships and partners, estates and beneficiaries, trusts and beneficiaries, and corporations and stockholders. If any person has an option to acquire stock, such stock is considered as owned by such person. The term "option" includes an option to acquire such an option and each of a series of such options. The rules of section 318 (a) are applicable to the following sections:

(1) Section 302 (relating to redemption of stock);

(2) Section 304 (relating to redemption by related corporations);

(3) Section 306 (b) (1) (A) (relating to disposition of section 306 stock);

(4) Section 334 (b) (3) (C) (relating to basis of property received in certain liquidations of subsidiaries); and

(5) Section 382 (a) (3) (relating to special limitations on net operating loss carryovers).

Stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) of section 318 (a) is, for purposes of applying paragraph (1), (2), or (3) treated as actually owned by such person, except as provided in section 318 (a) (4) (B) and § 1.318–4.

(b) In applying section 318 (a) to determine the stock ownership of any person for any one purpose—

(1) A corporation shall not be considered to own its own stock by reason of section 318 (a) (2) (C) (ii),

(2) In any case in which an amount of stock owned by any person may be included in the computation more than one time—

(i) Such stock shall be used in such computation only once, and

(ii) Such stock shall be used in such computation in the manner in which it will impute to the person concerned the largest total stock ownership, and

(3) In determining the 50 percent requirement of section 318 (a) (2) (C) all of the stock owned actually and constructively by the person concerned shall be aggregated.

§ 1.318–2 Application of general rules.

(a) The application of paragraph (b) of § 1.318–1 may be illustrated by the following examples:

Example (1). H, an individual, owns all of the stock of Corporation A. Corporation A is not considered to own the stock owned by H in Corporation A.

Example (2). A owns 40 percent of the Brown Corporation and 50 percent of the Green Corporation. Under section 318 (a) (2) (C), the stock ownership of A in the Brown Corporation will be limited to 40 percent of such stock. No amount of the stock of the Brown Corporation considered to be owned by the Green Corporation under section 318 (a) (2) (C) (ii) will be considered as owned by A under section 318 (a) (2) (C) (i) since, under paragraph (b) (2) (i) of § 1.318–1, the same stock shall not be taken into account twice in the same computation, and pursuant to paragraph (b) (2) (ii) of § 1.318–1, the amount of stock must be computed as if actually owned by A since this will impute to him the largest total stock ownership. The same result will follow if A is a fifty percent beneficiary of a trust or a fifty percent partner in a partnership rather than a 50 percent shareholder of the Green Corporation.

Example (3). Two unrelated individuals, A and B, own stock of a corporation, and are also the beneficiaries of a trust or estate or the members of a partnership. In determining the stock constructively owned by A, the trust, estate or partnership is considered as actually owning the stock owned by B.

Example (4). H, an individual, his wife, W, and his son, S, each own one-third of the stock of the Green Corporation. For purposes of determining the amount of stock owned by H, W, or S for the purpose of section 318 (a) (2) (C), the amount of stock held by the other members of the family shall be added pursuant to paragraph (b) (3) of § 1.318–1 above in applying the 50 percent requirement of such section. H, W, or S, as the case may be, is for this purpose deemed to own 100 percent of the stock of the Green Corporation.

(b) The application of section 318 (a) (1), relating to members of a family, may be illustrated by the following example:

Example. An individual, H, his wife, W, his son, S, and his grandson (S's son), G, own the 100 outstanding shares of stock of a corporation, each owning 25 shares. H, W, and S are each considered as owning 100 shares. G is considered as owning only 50 shares, that is, his own and his father's.

(c) The application of section 318 (a) (2) relating to partnerships, trusts and corporations may be illustrated by the following examples:

Example (1). A, an individual, has a 50 percent interest in a partnership. The partnership owns 50 of the 100 outstanding shares of stock of a corporation, the remaining 50 shares being owned by A. The partnership is considered as owning 100 shares. A is considered as owning 75 shares.

Example (2). A testamentary trust owns 25 of the outstanding 100 shares of stock of a corporation. A, an individual, who holds a vested remainder in the trust having a value, computed actuarially equal to 4 percent of the value of the trust property, owns the remaining 75 shares. Since the interest of A in the trust is a vested interest rather than a contingent interest (whether or not remote), the trust is considered as owning 100 shares. A is considered as owning 76 shares.

Example (3). The facts are the same as in (2), above, except that A's interest in the trust is a contingent remainder. A is considered as owning 76 shares. However, since A's interest in the trust is a remote contingent interest, the trust is not considered as owning any of the shares owned by A.

Example (4). A and B, unrelated individuals, own 70 percent and 30 percent, respectively, in value of the stock of Corporation M. Corporation M owns 50 of the 100 outstanding shares of stock of Corporation O, the remaining 50 shares being owned by A. Corporation M is considered as owning 100 shares of Corporation O, and A is considered as owning 85 shares.

Example (5). A and B, unrelated individuals, own 70 percent and 30 percent, respectively, of the stock of Corporation M. A, B and Corporation M all own stock of Corporation O. Since B owns less than 50 percent in value of the stock of Corporation M, neither B nor Corporation M constructively owns the stock of Corporation O owned by the other. However, for the purpose of section 304 (b) (1), 304 (c) (2), and 382 (a) (3), section 318 (a) (2) (C) is applied without regard to the 50 percent limitation contained therein, and for such purposes, B constructively owns the stock of Corporation O owned by Corporation M, and Corporation M constructively owns the stock of Corporation O owned by B. Therefore, for such purpose, in determining the stock constructively owned by A, Corporation M is treated as actually owning the stock of Corporation O owned by B.

§ 1.318–3 Estates, trusts, and options.

(a) For the purpose of applying section 318(a), relating to estates, property of a decedent shall be considered as owned by his estate if such property is subject to administration by the executor or adminstrator for the purpose of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death. The term "beneficiary" includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution. A person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him, when he no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When, pursuant to the preceding sentence, a person ceases to be a beneficiary, stock owned by him shall not thereafter be considered owned by the estate, and stock owned by the estate shall not thereafter be considered owned by him. The application of section 318 (a) relating to estates may be illustrated by the following examples:

Example (1). A decedent's estate owns 50 of the 100 outstanding shares of stock of Corporation X. The remaining shares are owned by three unrelated individuals, A, B, and C, who together own the entire interest in the estate. A owns 12 shares of stock of Corporation X directly and is entitled to 50 percent of the estate. B owns 18 shares directly and has a life estate in the remaining 50 percent of the estate. C owns 20 shares directly and also owns the remainder interest after B's life estate. Under these circumstances, the estate is considered as owning 80 shares of the stock of Corporation X; 50 shares directly, 12 shares constructively through A, and 18 shares constructively through B. A is considered as owning 46 shares of the stock of Corporation X; 12 shares directly and 34 shares constructively (50 percent of the 50 shares owned directly by the estate and 50 percent of the 18 shares owned constructively by the estate through B). B is considered as owning 49 shares of the stock of Corporation X; 18 shares directly and 31 shares constructively (50 percent of the 50 shares owned directly by the estate and 50 percent of the 12 shares owned constructively by the estate through A). C is considered as owning 20 shares directly and no shares constructively. C is not considered a beneficiary of the estate under section 318 (a) since he has no direct present interest in the property held by the estate nor in the income produced by such property.

Example (2). Under the will of A, Blackacre is left to B for life, remainder to C, an unrelated individual. The residue of the estate consisting of stock of a corporation is left to D. B and D are beneficiaries of the estate under section 318 (a). C is not considered a beneficiary since he has no direct present interest in Blackacre nor in the income produced by such property. The stock owned by the estate is considered as owned proportionately by B and D.

(b) For the purpose of section 318 (a) (2) (B) stock owned by a trust will be considered as being owned by its beneficiaries only to the extent of the interest of such beneficiaries in the trust. Accordingly, the interest of income beneficiaries, remainder beneficiaries, and other beneficiaries will be computed on an actuarial basis. Thus, if a trust owns 100 percent of the stock of Corporation A, and if, on an actuarial basis, W's life interest in the trust is 15 percent, Y's life interest is 25 percent, and Z's remainder interest is 60 percent, under this provision W will be considered

to be the owner of 15 percent of the stock of Corporation A, Y will be considered to be the owner of 25 percent of such stock, and Z will be considered to be the owner of 60 percent of such stock. The factors and methods prescribed in § 20.2031–7 of this chapter (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used in determining a beneficiary's actuarial interest in a trust for purposes of this section. See § 20.2031–7 of this chapter (Estate Tax Regulations) for examples illustrating the use of these factors and methods.

(c) The application of section 318 (a) relating to options may be illustrated by the following example:

Example. A and B, unrelated individuals, own all of the 100 outstanding shares of stock of a corporation, each owning 50 shares. A has an option to acquire 25 of B's shares and has an option to acquire a further option to acquire the remaining 25 of B's shares. A is considered as owning the entire 100 shares of stock of the corporation.

§ 1.318–4 Constructive family ownership.

An exception concerning the treatment of constructive ownership as actual ownership is provided in section 318 (a) (4) (B) with respect to stock constructively owned by reason of ownership by a member of a family. This exception is intended to make clear that unless the stock is directly attributable to the individual whose stock ownership is in question, the constructive ownership rules of section 318 (a) (1) are not applicable. Thus, for example, if F and his two sons, A and B, each own one-third of the stock of a corporation, under section 318 (a) (1), A is treated as owning constructively the stock owned by his father but is not treated as owning the stock owned by B. Section 318 (a) (4) (B) prevents the attribution of the stock of one brother through the father to the other brother, an attribution beyond the scope of section 318 (a) (1) directly.

CORPORATE LIQUIDATIONS

EFFECTS ON RECIPIENTS

§ 1.331 Statutory provisions; gain or loss to shareholders in corporate liquidations.

SEC. 331. *Gain or loss to shareholders in corporate liquidations*—(a) *General rule*—(1) *Complete liquidations.* Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(2) *Partial liquidations.* Amounts distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for the stock.

(b) *Nonapplication of section 301.* Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property in partial or complete liquidation.

(c) *Cross references.* (1) For general rule for determination of the amount of gain or loss to the distributee, see section 1001.

(2) For general rule for determination of the amount of gain or loss recognized, see section 1002.

§ 1.331–1 Corporate liquidations.

(a) Section 331 contains rules governing the extent to which gain or loss is recognized to a shareholder receiving a distribution in complete or partial liquidation of a corporation. Under section 331(a)(1), it is provided that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Under section 331(a)(2), it is provided that amounts distributed in partial liquidation of a corporation shall be treated as in full or part payment in exchange for the stock. For this purpose, the term "partial liquidation" shall have the meaning ascribed in section 346. If section 331 is applicable to the distribution of property by a corporation, section 301 (relating to the effects on a shareholder of distributions of property) has no application.

(b) The gain or loss to a shareholder from a distribution in partial or complete liquidation is to be determined under section 1001 by comparing the amount of the distribution with the cost or other basis of the stock. The gain or loss will be recognized to the extent provided in section 1002 and will be subject to the provisions of parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code.

(c) A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See sections 301 and 356.

(d) In every case in which a shareholder transfers stock in exchange for property to the corporation which issued such stock, the facts and circumstances shall be reported on his return unless the property is part of a distribution made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation and the corporation is completely liquidated and dissolved within one year after the distribution. See section 6043 for requirements relating to returns by corporations.

(e) The provisions of this section may be illustrated by the following example:

Example. A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1951 at a cost of $1,500 and the remainder of 10 shares in December 1954 at a cost of $2,900. He receives in April 1955 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1951, and $2,500 on the 10 shares acquired in December 1954. The gain of $1,000 on the shares acquired in 1951 is a long-term capital gain to be treated as provided in parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code. The loss of $400 on the shares acquired in 1954 is a short-term capital loss to be treated as provided in parts I, II, and III (section 1201 and following), subchapter P, chapter 1 of the Code.

§ 1.332 Statutory provisions; complete liquidations of subsidiaries.

SEC. 332. *Complete liquidations of subsidiaries*—(a) *General rule.* No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) *Liquidations to which section applies.* For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if—

(1) The corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends); and either

(2) The distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(3) Such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year, the Secretary or his delegate may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such 3-year period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, the assessment and collection of all income taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this subsection shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for purposes of this subsection a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (A) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, on an exchange described in section 361, and (B) the complete cancellation or redemption under the plan, as a result of exchanges described in section 354, of the shares not owned by the taxpayer.

(c) *Special rule for indebtedness of subsidiary to parent.* If—

(1) A corporation is liquidated and subsection (a) applies to such liquidation, and

(2) On the date of the adoption of the plan of liquidation, such corporation was

indebted to the corporation which meets the 80 percent stock ownership requirements specified in subsection (b),

then no gain or loss shall be recognized to the corporation so indebted because of the transfer of property in satisfaction of such indebtedness.

§ 1.332–1 Distributions in liquidation of subsidiary corporation; general.

Under the general rule prescribed by section 331 for the treatment of distributions in liquidation of a corporation, amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation, and gain or loss from the receipt of such amounts is to be determined as provided in section 1001. Section 332 excepts from the general rule property received, under certain specifically described circumstances, by one corporation as a distribution in complete liquidation of the stock of another corporation and provides for the nonrecognition of gain or loss in those cases which meet the statutory requirements. Section 367 places a limitation on the application of section 332 in the case of foreign corporations. See section 334(b) for the basis for determining gain or loss from the subsequent sale of property received upon complete liquidations such as described in this section. See section 453 (d) (4) (A) relative to distribution of installment obligations by subsidiary.

§ 1.332–2 Requirements for nonrecognition of gain or loss.

(a) The nonrecognition of gain or loss is limited to the receipt of such property by a corporation which is the actual owner of stock (in the liquidating corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends). The recipient corporation must have been the owner of the specified amount of such stock on the date of the adoption of the plan of liquidation and have continued so to be at all times until the receipt of the property. If the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation and if the failure to continue qualified occurs at any time prior to the completion of the transfer of all the property, the provisions for the nonrecognition of gain or loss do not apply to any distribution received under the plan.

(b) Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165 (g) relative to allowance of losses on worthless securities.

(c) To constitute a distribution in complete liquidation within the meaning of section 332, the distribution must be (1) made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or (2) one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation. Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed. Liquidation is completed when the liquidating corporation and the receiver or trustees in liquidation are finally divested of all the property (both tangible and intangible). A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction. (See 26 CFR (1939) 39.22(a)–20 (Regulations 118).)

(d) If a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code of 1954 and satisfies the requirements of section 332, it is not material that it is otherwise described under the local law. If a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Code and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all of the stock of the liquidating corporation within the meaning of section 332, even though for purposes of those provisions relating to corporate reorganizations the amount received by the recipient corporation in excess of its ratable share is regarded as acquired upon the issuance of its stock or securities in a tax-free exchange as described in section 361 and the cancellation or redemption of the stock not owned by the recipient corporation is treated as occurring as a result of a tax-free exchange described in section 354.

(e) The application of these rules may be illustrated by the following example:

Example. On September 1, 1954, the M Corporation had outstanding capital stock consisting of 3,000 shares of common stock, par value $100 a share, and 1,000 shares of preferred stock, par value $100 a share, which preferred stock was limited and preferred as to dividends and had no voting rights. On that date, and thereafter until the date of dissolution of the M Corporation, the O Corporation owned 2,500 shares of common stock of the M Corporation. By statutory merger consummated on October 1, 1954, pursuant to a plan of liquidation adopted on September 1, 1954, the M Corporation was merged into the O Corporation, the O Corporation under the plan issuing stock which was received by the other holders of the stock of the M Corporation. The receipt by the O Corporation of the properties of the M Corporation is a distribution received by the O Corporation in complete liquidation of the M Corporation within the meaning of section 332, and no gain or loss is recognized as the result of the receipt of such properties.

§ 1.332–3 Liquidations completed within one taxable year.

If in a liquidation completed within one taxable year pursuant to a plan of complete liquidation, distributions in complete liquidation are received by a corporation which owns the specified amount of stock in the liquidating corporation and which continues qualified with respect to the ownership of such stock until the transfer of all the property within such year is completed (see paragraph (a) of § 1.332–2), then no gain or loss shall be recognized with respect to the distributions received by the recipient corporation. In such case no waiver or bond is required of the recipient corporation under section 332.

§ 1.332–4 Liquidations covering more than one taxable year.

(a) If the plan of liquidation is consummated by a series of distributions extending over a period of more than one taxable year, the nonrecognition of gain or loss with respect to the distributions in liquidation shall, in addition to the requirements of § 1.332–2, be subject to the following requirements:

(1) In order for the distribution in liquidation to be brought within the exception provided in section 332 to the general rule for computing gain or loss with respect to amounts received in liquidation of a corporation, the entire property of the corporation shall be transferred in accordance with a plan of liquidation, which plan shall include a statement showing the period within which the transfer of the property of the liquidating corporation to the recipient corporation is to be completed. The transfer of all the property under the liquidation must be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan.

(2) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation shall, at the time of filing its return, file with the district director of internal revenue a waiver of the statute of limitations on assessment. The waiver shall be executed on such form as may be prescribed by the Commissioner and shall extend the period of assessment of all income and profits taxes for each such year to a date not earlier than one year after the last date of the period for assessment of such taxes for the last taxable year in which the transfer of the property of such liquidating corporation to the controlling corporation may be completed in accordance with section 332. Such waiver shall also contain such other terms with respect to assessment as may be considered by the Commissioner to be necessary to insure the assessment and collection of the correct tax liability for each year within the period of liquidation.

(3) For each of the taxable years which falls wholly or partly within the period of liquidation, the recipient corporation may be required to file a bond, the amount of which shall be fixed by the district director. The bond shall contain all terms specified by the Commissioner, including provisions unequivocally assuring prompt payment of the excess of income and profits taxes (plus penalty, if any, and interest) as computed by the district director without regard to the provisions of sections 332 and 334(b) over such taxes computed with regard to such provisions, regardless of whether such excess may or may not be made the subject of a notice of deficiency under section 6212 and regardless of whether it may or may not be assessed. Any bond required under section 332 shall have such surety or sureties as the Commissioner may require. However, see 6 U.S.C. 15, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on Federal bonds will be approved as sureties. The bonds shall be executed in triplicate so that the Commissioner, the taxpayer, and the surety or the depositary may each have a copy. On and after September 1, 1953, the functions of the Commissioner with respect to such bonds shall be performed by the district director for the internal revenue district in which the return was filed and any bond filed on or after such date shall be filed with such district director.

(b) Pending the completion of the liquidation, if there is a compliance with paragraph (a) (1), (2), and (3) of this section and § 1.332–2 with respect to the nonrecognition of gain or loss, the income and profits tax liability of the recipient corporation for each of the years covered in whole or in part by the liquidation shall be determined without the recognition of any gain or loss on account of the receipt of the distributions in liquidation. In such determination, the basis of the property or properties received by the recipient corporation shall be determined in accordance with section 334 (b). However, if the transfer of the property is not completed within the three-year period allowed by section 332 or if the recipient corporation does not continue qualified with respect to the ownership of stock of the liquidating corporation as required by that section, gain or loss shall be recognized with respect to each distribution and the tax liability for each of the years covered in whole or in part by the liquidation shall be recomputed without regard to the provisions of section 332 or section 334 (b) and the amount of any additional tax due upon such recomputation shall be promptly paid.

§ 1.332–5 Distributions in liquidation as affecting minority interests.

Upon the liquidation of a corporation in pursuance of a plan of complete liquidation, the gain or loss of minority shareholders shall be determined without regard to section 332, since it does not apply to that part of distributions in liquidation received by minority shareholders.

§ 1.332–6 Records to be kept and information to be filed with return.

(a) Permanent records in substantial form shall be kept by every corporation receiving distributions in complete liquidation within the exception provided in section 332 showing the information required by this section to be submitted with its return. The plan of liquidation must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of each such corporation.

(b) For the taxable year in which the liquidation occurs, or, if the plan of liquidation provides for a series of distributions over a period of more than one year, for each taxable year in which a distribution is received under the plan the recipient must file with its return a complete statement of all facts pertinent to the nonrecognition of gain or loss, including:

(1) A certified copy of the plan for complete liquidation, and of the resolutions under which the plan was adopted and the liquidation was authorized, together with a statement under oath showing in detail all transactions incident to, or pursuant to, the plan.

(2) A list of all the properties received upon the distribution, showing the cost or other basis of such properties to the liquidating corporation at the date of distribution and the fair market value of such properties on the date distributed.

(3) A statement of any indebtedness of the liquidating corporation to the recipient corporation on the date the plan of liquidation was adopted and on the date of the first liquidating distribution. If any such indebtedness was acquired at less than face value, the cost thereof to the recipient corporation must also be shown.

(4) A statement as to its ownership of all classes of stock of the liquidating corporation (showing as to each class the number of shares and percentage owned and the voting power of each share) as of the date of the adoption of the plan of liquidation, and at all times since, to and including the date of the distribution in liquidation. The cost or other basis of such stock and the date or dates on which purchased must also be shown.

§ 1.332–7 Indebtedness of subsidiary to parent.

If section 332(a) is applicable to the receipt of the subsidiary's property in complete liquidation, then no gain or loss shall be recognized to the subsidiary upon the transfer of such properties even though some of the properties are transferred in satisfaction of the subsidiary's indebtedness to its parent. However, any gain or loss realized by the parent corporation on such satisfaction of indebtednes, shall be recognized to the parent corporation at the time of the liquidation. For example, if the parent corporation purchased its subsidiary's bonds at a discount and upon liquidation of the subsidiary the parent corporation receives payment for the face amount of such bonds, gain shall be recognized to the parent corporation. Such gain shall be measured by the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds.

§ 1.333 Statutory provisions; election as to recognition of gain in certain liquidations.

SEC. 333. *Election as to recognition of gain in certain liquidations*—(a) *General rule.* In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which section 341 (a) applies), if—

(1) The liquidation is made in pursuance of a plan of liquidation adopted on or after June 22, 1954, and

(2) The distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

(b) *Excluded corporation.* For purposes of this section, the term "excluded corporation" means a corporation which at any time between January 1, 1954, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(c) *Qualified electing shareholders.* For purposes of this section, the term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subsection (a) has been made and filed in accordance with subsection (d), but—

(1) In the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 percent of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; or

(2) In the case of a shareholder which is a corporation, only if written elections have been so filed by corporate shareholders (other than an excluded corporation) which at the time of the adoption of such plan of liquidation are owners of stock possessing at least 80 percent of the total combined voting power (exclusive of voting power possessed by stock owned by an excluded corporation and by shareholders who are not corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation.

(d) *Making and filing of elections.* The written elections referred to in subsection (c) must be made and filed in such manner as to be not in contravention of regulations prescribed by the Secretary or his delegate. The filing must be within 30 days after the date of the adoption of the plan of liquidation.

(e) *Noncorporate shareholders.* In the case of a qualified electing shareholder other than a corporation—

(1) There shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a) (2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) There shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

(f) *Corporate shareholders.* In the case of a qualified electing shareholder which is a corporation, the gain shall be recognized only to the extent of the greater of the two following—

(1) The portion of the assets received by it which consists of money, or of stock or securities acquired by the liquidating corporation after December 31, 1953; or

(2) Its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a) (2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed.

§ 1.333–1 Corporate liquidation in some one calendar month.

(a) *In general.* Section 333 provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations (other than collapsible corporations to which section 341(a) applies) occurring within some one calendar month, for the treatment of gain on the shares of stock owned by qualified electing shareholders at the time of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 333. The determination of who is a qualified electing shareholder is to be made under section 333(c). For the basis of property received on such liquidations, see section 334 (c). Section 333 has no application to collapsible corporations. See section 341 (b) for definition of collapsible corporations.

(b) *Type of liquidation.* (1) The liquidation must be in pursuance of a plan of liquidation adopted on or after June 22, 1954. The plan must be adopted before the first distribution under the liquidation occurs. The 1954 Code requires that the transfer of all the property, both tangible and intangible, of the corporation to its shareholders shall occur entirely within some one calendar month. This requirement will be considered to have been complied with if cash is set aside under arrangements for the payment, after the close of such month, of unascertained or contingent liabilities and expenses, and such arrangements are made in good faith and the amount set aside is reasonable. It is not necessary that the month in which the transfer occurs must fall within the taxable or calendar year in which the plan of liquidation is adopted. Though it is not necessary that the corporation dissolve in the month of liquidation, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation. A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders.

(2) If a transaction constitutes a distribution in complete liquidation within the meaning of the Code and satisfies the requirements of section 333, it is immaterial that it is otherwise described under the local law.

§ 1.333–2 Qualified electing shareholder.

(a) No corporate shareholder may be a qualified electing shareholder if at any time between January 1, 1954, and the date of the adoption of the plan of liquidation, both dates inclusive, it is the owner of stock of the liquidating corporation possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote upon the adoption of the plan of liquidation. All other shareholders are divided into two groups for the purpose of determining whether they are qualified electing shareholders: (1) shareholders other than corporations, and (2) corporate shareholders.

(b) Any shareholder of either of such two groups, whether or not the stock he owns is entitled to vote on the adoption of the plan of liquidation, is a qualified electing shareholder if:

(1) His written election to be governed by the provisions of section 333, which cannot be withdrawn or revoked, has been made and filed as prescribed in § 1.333–3; and

(2) Like elections have been made and filed by owners of stock possessing at least 80 percent of the total combined voting power of all classes of stock owned by shareholders of the same group at the time of, and entitled to vote upon, the adoption of the plan of liquidation, whether or not the shareholders making such elections actually realize gain upon the cancellation or redemption of such stock upon the liquidation.

(c) The application of this section may be illustrated by the following example:

Example. The R Corporation has outstanding 20 shares of common stock on July 1, 1954, at the time of the adoption of a plan of liquidation within the provisions of section 333, each entitled to one vote upon the adoption of such plan of liquidation. At that time ten of such shares are owned by the S Corporation, two each by the X Corporation and the Y Corporation, one by the Z Corporation, and one each by A, B, C, D, and E, individuals. There are also outstanding at such time two shares of preferred stock, not entitled to vote on liquidation, one share being owned by F, an individual, and one share by the P Corporation. The S Corporation, being a corporate shareholder and the owner of 50 percent of the voting stock, may not be a qualified electing shareholder under any circumstances. In order for any other corporate shareholder to be a qualified electing shareholder, it is necessary that the X Corporation and the Y Corporation file their written elections to be governed by section 333. If this is done, the P Corporation will also be a qualified electing shareholder if it has filed a like election. Similarly, in the case of the individual shareholders, some combination of four of the individual holders of the common stock must have filed their written elections, before any individual shareholder may be considered a qualified electing shareholder, but if this is done, F will also be a qualified electing shareholder if he has filed a like election.

(d) An election to be governed by the provisions of section 333 relates to the treatment of gain realized upon the cancellation or redemption of stock upon liquidation. Such election, therefore, can be made only by or on behalf of the person by whom gains, if any, will be realized. Thus, the shareholder who may make such election must be the actual owner of stock and not a mere record holder, such as a nominee.

(e) A shareholder is entitled to make an election relative to the gain only on stock owned by him at the time of the adoption of the plan of liquidation. The election is personal to the shareholder making it and does not follow such stock into the hands of a transferee.

§ 1.333–3 Making and filing of written elections.

An election to be governed by section 3.3 shall be made on Form 964 (revised) in accordance with the instructions printed thereon and with this section. The original and one copy shall be filed by the shareholder with the district director with whom the final income tax return of the corporation will be filed. The elections must be filed within 30 days after the adoption of the plan of liquidation.

Under no circumstances shall section 333 be applicable to any shareholders who fail to file their elections within the 30-day period prescribed. An election shall be considered as timely filed if it is placed in the mail on or before midnight of the 30th day after the adoption of the plan of liquidation, as shown by the postmark on the envelope containing the written election or as shown by other available evidence of the mailing date. Another copy ofthe election shall be attached to and made a part of the shareholder's income tax return for his taxable year in which the transfer of all the property under the liquidation occurs.

§ 1.333–4 Treatment of gain.

(a) *Computation of gain.* As in the case of shareholders generally, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 331 and gain from the receipt of such amounts is determined as provided in section 1001. Gain or loss must be computed separately on each share of stock owned by a qualified electing shareholder at the time of the adoption of the plan of liquidation. The limited recognition and special treatment accorded by section 333 applies only to the gain on such shares of stock upon which gain was realized and not to net gain computed by setting off losses realized on some shares against gain on others. Since section 333 applies only to gain recognized, losses realized on the liquidation will be allowable only in the year of liquidation even though Forms 964 (revised) have been filed by those shareholders who realize only losses. Such filings may be necessary to fulfill the 80 percent requirement (under section 333(c)) so that those shareholders who realize gain may qualify under this section.

(b) *Recognition of gain.* Pursuant to section 333 only so much of the gain on each share of stock owned by a qualified electing shareholder at the time of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following:

(1) Such share's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, computed as of the last day of the month of liquidation, without diminution by reason of distributions made during such month, and including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after December 31, 1953. The mere replacement after December 31, 1953 of lost or destroyed certificates or instruments acquired on or before December 31, 1953, or the mere conversion of certificates or instruments into certificates or instruments of larger or smaller denominations will not constitute an acquisition within the meaning of the phrase "acquired after December 31, 1953." Nor will such an acquisition result from the issuance after December 31, 1953 of certificates of stock in connection with a subscription made and accepted on or before December 31, 1953.

(c) *Treatment of recognized gain.* (1) In the case of a qualified electing shareholder other than a corporation, that part of the recognized gain on a share of stock owned at the time of the adoption of the plan of liquidation which is not in excess of his ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section 333(e)(1), is treated as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated as a short-term or long-term capital gain, as the case may be. In the case of a qualified electing shareholder which is a corporation, the entire amount of the gain which is recognized is treated as a short-term or long-term capital gain, as the case may be.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) X Corporation has only one class of stock outstanding, owned in equal amounts by three shareholders. The basis of the stock owned by each shareholder is $50, each having bought his stock in a single block prior to the date of the adoption of a plan of liquidation conforming to the requirements of section 333. One of the shareholders is an individual; two are corporations. All are "qualified electing shareholders".

(ii) X Corporation has earnings and profits accumulated after February 28, 1913, of $60 (computed as provided in section 333). Its assets consist of (*a*) cash of $75, (*b*) stock and securities acquired after December 31, 1953, having a fair market value of $90, and (*c*) other property having a fair market value of $240. In October 1954, all of these assets are distributed to the shareholders pro rata in complete liquidation of the corporation, as provided in section 333. Each shareholder thus receives $135 in cash and property, and has $85 gain.

(iii) Each shareholder's gain is recognized to the extent of $55 since such amount represents the sum of (*a*) the cash received by him and (*b*) the fair market value of the stock and securities received by him which were acquired by the X Corporation after December 31, 1953, and is greater than his ratable share of the earnings and profits ($20). The remainder of each shareholder's gain ($30) is not recognized.

(iv) In the case of the corporate shareholders the entire amount of the recognized gain ($55) is treated as capital gain. In the case of the individual shareholder, $20, being the amount of the shareholder's ratable share of the earnings and profits, is recognized and treated as a dividend. and $35, being the difference between the shareholder's ratable share of the earnings and profits and the sum of the cash and stock and securities received by him, is treated as a short-term or long-term capital gain, as the case may be.

(v) If the basis of each shareholder's stock had been $100, instead of $50, each of the corporate shareholders would be taxed on only $35 as capital gain and the individual shareholder would be taxed on $20 as a dividend and on only $15 as capital gain, since the total amount taxed is limited to the amount of gain realized by the shareholder upon the cancellation or redemption of his stock.

§ 1.333–5 Records to be kept and information to be filed with return.

(a) Permanent records in substantial form shall be kept by every qualified electing shareholder receiving distributions in complete liquidation of a domestic corporation. Such shareholder must file with his income tax return for his taxable year in which the liquidation occurs a statement of all facts pertinent to the recognition and treatment of the gain realized by him upon the shares of stock owned by him at the time of the adoption of the plan of liquidation, including:

(1) A statement of his stock ownership in the liquidating corporation as of the date of the distribution, showing the number of shares of each class owned on such date and the cost or other basis of each such share;

(2) A list of all the property, including money, received upon the distribution, showing the fair market value of each item of such property other than money on the date distributed and stating what items, if any, consist of stock or securities acquired by the liquidating corporation after December 31, 1953.

(3) A statement of his ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, computed without diminution by reason of distributions made during the month of liquidation; and

(4) A copy of such shareholder's written election to be governed by the provisions of section 333. See § 1.333–3.

(b) For information to be filed by the liquidating corporation, see section 6043.

§ 1.334 Statutory provisions; basis of property received in liquidations.

SEC. 334. *Basis of property received in liquidations*—(a) *General rule.* If property is received in a distribution in partial or complete liquidation (other than a distribution to which section 333 applies), and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

(b) *Liquidation of subsidiary*—(1) *In general.* If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332 (b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332 (c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) *Exception.* If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332 (b)), and if—

(A) The distribution is pursuant to a plan of liquidation adopted—

(i) On or after June 22, 1954, and

(ii) Not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) Stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a period of not more than 12 months,

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of

liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) *Purchase defined.* For purposes of paragraph (2) (B), the term "purchase" means any acquisition of stock, but only if—

(A) The basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014 (a) (relating to property acquired from a decedent),

(B) The stock is not acquired in an exchange to which section 351 applies, and

(C) The stock is not acquired from a person the ownership of whose stock would, under section 318 (a), be attributed to the person acquiring such stock.

(4) *Distributee defined.* For purposes of this subsection, the term "distributee" means only the corporation which meets the 80 percent stock ownership requirements specified in section 332 (b).

(c) *Property received in liquidation under section 333.* If—

(1) Property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) With respect to such acquisition—

(A) Gain was realized, but

(B) As the result of an election made by the shareholder under section 333, the extent to which gain was recognized was determined under section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him.

§ 1.334–1 Basis of property received in liquidations.

(a) *In general.* Section 334 sets forth rules prescribing the basis of property received in a distribution in partial or complete liquidation of a corporation. The general rule of section 334 is set forth in section 334(a) to the effect that if property is received in a distribution in partial or complete liquidation and if gain or loss is recognized on the receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution. Such general rule has no application to a liquidation to which section 332 or section 333 applies. See section 334 (b) and (c).

(b) *Transferor's basis.* Unless section 334 (b) (2) and subsection (c) of this section apply, property received by a parent corporation in a complete liquidation to which section 332 is applicable shall, under section 334 (b) (1), have the same basis in the hands of the parent as its adjusted basis in the hands of the subsidiary. The rule stated above is applicable even though the subsidiary was indebted to the parent on the date the plan of liquidation was adopted and part of such property was received in satisfaction of such indebtedness in a transfer to which section 332 (c) is applicable.

(c) *Application of stock basis to property.* If section 334 (b) (2) applies to a complete liquidation to which section 332 is applicable, then property received by a parent corporation in such complete liquidation shall have a basis determined by reference to the basis of the stock of the subsidiary corporation with respect to which it is received. In general, section 334 (b) (2) will be applicable to a distribution in complete liquidation of a subsidiary corporation if the parent corporation purchased, within the meaning of section 334 (b) (3) and during a period of not more than twelve months, 80 percent or more of the stock (other than nonvoting stock which is limited and preferred as to dividends) of the subsidiary corporation, and then adopted a plan of liquidation (on or after June 22, 1954) not more than two years after the date on which the stock ownership requirement was met. The application of section 334 (b) (2) is subject to the following rules:

(1) Property received with reference to stock owned immediately before the liquidation by the parent corporation is the only property to which section 334 (b) (2) is applicable. The section is not applicable to property received with respect to debt or other claims. The basis of the stock used in determining the basis of the assets is the total basis of all stock held by the parent corporation whether or not such stock was acquired by purchase and whether or not such stock is the stock acquired during the period to which reference is made in section 334 (b) (2) (A).

(2) The date of adoption of a plan of liquidation is determined under section 332 (b) (2).

(3) (i) Except as provided in subdivision (ii) of this subparagraph, in the case of a series of purchases of stock, the two-year period specified in section 334 (b) (2) (A) shall begin on the day following the earliest date which is the end of a period of twelve months or less within which the amount of stock required by section 334 (b) (2) (B) was acquired. For example, assume that 20 percent of the stock of corporation A is purchased on each of the following dates: April 1, 1956, June 30, 1956, September 30, 1956, December 31, 1956, and June 1, 1957. The two-year period shall begin on January 1, 1957. However, if the first purchase of 20 percent of the stock occurs on November 1, 1955 (instead of April 1, 1956), then the two-year period shall begin on June 2, 1957.

(ii) If a plan of liquidation is adopted on or before December 24, 1958, subdivision (i) of this subparagraph shall not apply and the rule of subdivision (iii) of this subparagraph shall apply unless the parent corporation elects to have the rule of subdivision (i) of this subparagraph apply. Such election shall be made by the parent corporation either in a statement attached to its return (filed within the time prescribed for filing, including any extensions of time) for the taxable year within which such plan is adopted, or in a statement filed on or before September 22, 1958, with the district director with whom such corporation's return for such taxable year was filed. The election, once made, shall be irrevocable.

(iii) The rule referred to in subdivision (ii) of this subparagraph is as follows:

(*a*) In the case of a series of purchases of stock, the two-year period specified in section 334 (b) (2) (A) shall begin on the day following the date of the last such purchase if the amount of stock specified in section 334 (b) (2) (B) is purchased during the preceding twelve months.

(*b*) Application of the rule prescribed in (*a*) of this subdivision may be illustrated by the following example:

Example. Twenty percent of the stock of corporation A is purchased on each of the following dates: April 1, 1954, June 30, 1954, September 30, 1954, December 31, 1954, and April 1, 1955. Although 80 percent of the stock of corporation A had been purchased as of December 31, 1954, the date of the last transaction of the series of transactions described in section 334 (b) (2) (B) is April 1, 1955, and therefore the two-year period shall begin on April 2, 1955.

(4) For the purpose of section 334 (b) (2) only, the following adjustments shall be made to the adjusted basis of the subsidiary's stock in the hands of the parent:

(i) Such adjusted basis shall be reduced by the amount of all distributions received by the parent from the subsidiary during the period beginning on the day on which the stock used in determining the applicability of section 334 (b) (2) was purchased (or if such stock was purchased on more than one day, on the day of the earliest purchase of the stock so used) and ending when the plan of liquidation is adopted.

(ii) In order to apply the rule of subdivision (i) of this subparagraph the amount of a distribution in kind shall be whichever of the following is the greater:

(*a*) The amount described in section 301 (b) (1) (B) (ii) (regardless of the amount of the distribution under section 301 (b)), or

(*b*) The portion of the adjusted basis of the stock allocable to the property so distributed.

(iii) The reduction provided in subdivision (i) of this subparagraph shall be made whether or not such distributions were taxable to the parent as ordinary dividends.

(iv) The reduction provided in subdivision (i) of this subparagraph shall not be made—

(*a*) To the extent that a reduction in the adjusted basis of the stock is required by section 301 (c) (2); or

(*b*) To the extent that such distributions of the subsidiary are out of earnings and profits of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation.

(v) The adjusted basis of the subsidiary's stock held by the parent with respect to which the distributions in liquidation are made (reduced as in subdivision (i) of this subparagraph)—

(*a*) Shall be increased—

(*1*) By the amount of any unsecured liabilities assumed by the parent, and

(2) By the portion of the subsidiary's earnings and profits (less the amount of any distributions therefrom) of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation attributable to the stock of the subsidiary held by the parent.

(*b*) Shall be decreased:

(*1*) By the amount of any cash and its equivalent received, and

(2) By the portion of the subsidiary's deficit in earnings and profits of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation attributable to the stock of the subsidiary held by the parent.

(vi) For the purpose of subdivision (v) (*a*) (2) and (*b*) (2) of this subparagraph:

(*a*) With respect to property held on the date of purchase and property held on the date additional stock, if any, is acquired any gain or loss from sales or exchanges of such property (whether tangible or intangible) and any other items determined by reference to basis of such property shall be computed by substituting for such basis a new basis determined by reference to the part of the adjusted basis of the stock allocable to such property,

(*b*) The part of the adjusted basis of stock allocable to such property for the purpose of (*a*) of this subdivision shall be the basis of the stock held on the date of purchase or on the date of a later acquisition of stock allocated among the assets held on such date on the basis of their net fair market values on such date,

(*c*) In order to prevent distortion in the adjusted basis of the stock:

(*1*) Transactions (including distributions, liquidations, and reorganizations) involving a corporation the affairs of which the subsidiary controls at any time after the date of purchase through ownership of stock (whether or not the subsidiary owns a majority of the stock of such corporation) may be disregarded in whole or in part, and

(2) Tax-free reorganizations involving the subsidiary may be disregarded in whole or in part, and

(*d*) In the case of a subsidiary using the cash receipts and disbursements method of accounting, the earnings and profits of such subsidiary shall be computed for the period specified in subdivision (v) (*a*) (2) and (*b*) (2) of this subparagraph as if such subsidiary had used an accrual method of accounting prior to such period.

(vii) For the purposes of subdivisions (iv), (v), and (vi) of this subparagraph the expression "the date of purchase" means the date of the transaction described in section 334 (b) (2) (B) (or, in the case of a series of transactions, the date of the last such transaction), determined without regard to subparagraph (6) (iii) of this paragraph.

(viii) In the case of a distribution by the subsidiary of property directly or indirectly acquired by the subsidiary through a direct or indirect contribution to capital by the parent, the basis of such property to the parent shall be the same as if such contribution had not been made and the adjusted basis of the stock shall not be increased or decreased because of such contribution and distribution. Except as provided in the preceding sentence, the amount of the adjusted basis of the stock adjusted as provided in this paragraph shall be allocated as basis among the various assets received (except cash and its equivalent) both tangible and intangible (whether or not depreciable or amortizable). Ordinarily, such allocation shall be made in proportion to the net fair market values of such assets on the date received (the net fair market value of an asset being its fair market value less any specific mortgage or pledge to which it is subject). To that portion of the basis thus determined, for each property against which there is a lien, should be added the amount of such lien. Where more than one property is covered by the same lien, the amount of the lien should be divided among the properties, allocating to each that portion of the lien which the fair market value of such property bears to the total fair market value of the properties covered by the same lien. Whether the mortgage indebtedness is assumed by the parent or the property is taken subject to the mortgage is immaterial. The basis of the property received shall be zero if the cash and its equivalent received is equal to or in excess of the adjusted basis of the stock.

(5) The application of the rules prescribed in subparagraph (4) of this paragraph may be illustrated by the following examples:

Example (*1*). Corporation A bought all of the stock of Corporation B for $1,000 on January 1, 1955. The only asset of Corporation B was a building having a basis of $100. On July 1, 1955, such building was sold for $1,050. The amount received was invested in another building immediately thereafter. On December 30, 1955, Corporation B was liquidated under section 332 in a transaction in which the basis of the assets in the hands of the recipient corporation was determined under section 334 (b) (2). The basis of the stock of Corporation B in the hands of Corporation A is increased by $50 pursuant to paragraph (c) (4) (v) and (vi) of § 1.334–1. The basis of the building received by Corporation A upon the liquidation of Corporation B is $1,050.

Example (*2*). The facts are the same as in example (1) except that the sale price of the building sold was $750. The basis of the building in the hands of Corporation A upon liquidation is $750.

(6) For the purposes of section 334 (b) (2) the term "purchase" means any acquisition of stock, but only if—

(i) The basis of stock in the hands of the distributee is not determined either in whole or in part by reference to the adjusted basis of stock in the hands of the person from whom acquired, or under section 1014 (a) (relating to property acquired from the decedent);

(ii) The stock is not acquired in an exchange to which section 351 applies; and

(iii) The stock is not acquired from a person the ownership of whose stock would, under section 318 (a), be attributed to the person acquiring such stock. However, if a corporation acquires stock pursuant to an option to buy such stock from a person who, without regard to such option, is not a person the ownership of whose stock would, under section 318 (a), be attributed to such corporation, such stock shall be considered to have been purchased on the date of the acquisition of such option, if such option is exercised on or before the last day of a period of 12 months beginning on the day of the earliest purchase of stock (including the stock subject to such option) used in determining the applicability of section 334 (b) (2) and for this purpose the stock with respect to which the option was exercised shall be deemed to have been purchased on the date such option was acquired.

(7) Section 334 (b) does not apply to minority shareholders. The basis of property, other than cash, received by such shareholders shall be determined under section 334(a), 334(c), or 358.

§ 1.334–2 Property received in liquidation under section 333.

The basis of assets (other than money) acquired by stockholders in a liquidation upon which the amount of gain recognized was limited under section 333 shall be the same as the basis of the shares of stock redeemed or cancelled, decreased in the amount of any money received and increased in the amount of gain recognized and the amount of the unsecured liabilities assumed by the stockholders. The amount thus arrived at should be allocated to the various assets received on the basis of their net fair market values (the net fair market value of an asset is its fair market value less any specific mortgage or pledge to which it is subject). To that portion of the basis thus determined, for each property against which there is a lien, should be added the amount of such lien. Where more than one property is covered by the same lien, the amount of the lien should be divided among the properties, allocating to each that portion of the lien that the fair market value of such property bears to the total market value of the properties covered by the same lien. Whether the mortgage indebtedness is assumed by the shareholders or the property is taken subject to the mortgage is immaterial. The application of this section may be illustrated by the following example:

Example. The X corporation distributed all its property in complete liquidation during the month of October 1954 pursuant to the provisions of section 333. A, an individual, and a qualifying electing shareholder, received, in cancellation or redemption of 100 shares of stock owned by him at the time of the adoption of the plan of liquidation, $1,000 in cash, property (other than stock or securities acquired by the corporation after December 31, 1953) with a fair market value of $22,000 subject to a lien of $1,000, and stock acquired by the liquidating corporation after December 31, 1953 with a fair market value of $4,000. A, also assumed a $2,000 liability of the liquidating corporation. The basis of the shares owned by A was $120 per share or $12,000. A's ratable share of the earnings and profits of the X corporation accumulated after February 28, 1913 (computed as provided in section 333) was $2,500. His gain is $12,000, but under section 333 only $5,000 of this gain is recognized, $2,500 thereof being taxed as a dividend. The basis of all the property other than money received by A is $19,000, computed as follows:

Adjusted basis of stock cancelled or redeemed	$12,000
Less: money received	1,000
Remainder	11,000
Liability assumed	2,000
Specific lien against property (other than stock)	1,000
Gain recognized	5,000
Basis of property acquired	19,000

The basis, excluding the specific lien attached to the property, ($19,000 less $1,000, $18,000) will be apportioned among the classes of property other than money received as follows: $21,000/$25,000 of $18,000 or $15,120 to the property other than stock; $4,000/$25,000 of $18,000 or $2,880 to the stock. The basis of the property other than stock, $15,120, must be increased by the amount of the specific lien attached thereto, $1,000, making a total basis for such property of $16,120.

EFFECTS ON CORPORATION

§ 1.336 Statutory provisions; general rule.

SEC. 336. *General rule.* Except as provided in section 453 (d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

§ 1.336–1 General rule on liquidation of corporation.

Except as provided in section 453(d), no gain or loss is recognized to a corporation on the distribution by it of property in kind in partial or complete liquidation (regardless of the fact that such property may have appreciated or depreciated in value since its acquisition by the corporation). However, gain or loss is recognized to a corporation on all sales by it, whether directly or indirectly (as through trustees or a receiver), except as provided in section 337 (relating to sales or exchanges in connection with certain liquidations). See sections 61, 6036, 6155 (a), 6161 (c), 6503(b), 6601, 6871, 6872, and 6873.

§ 1.337 Statutory provisions; gain or loss on sales or exchanges in connection with certain liquidations.

SEC. 337. *Gain or loss on sales or exchanges in connection with certain liquidations*—(a) *General rule.* If—

(1) A corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) Within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

(b) *Property defined*—(1) *In general.* For purposes of subsection (a), the term "property" does not include—

(A) Stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) Installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) Installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) *Nonrecognition with respect to inventory in certain cases.* Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) Such property so sold or exchanged, and

(B) Installment obligations acquired in respect of such sale or exchange.

(c) *Limitations*—(1) *Collapsible corporations and liquidations to which section 333 applies.* This section shall not apply to any sale or exchange—

(A) Made by a collapsible corporation (as defined in section 341 (b)), or

(B) Following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation.

(2) *Liquidations to which section 332 applies.* In the case of a sale or exchange following the adoption of a plan of complete liquidation, if section 332 applies with respect to such liquidation, then—

(A) If the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b) (1), this section shall not apply; or

(B) If the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b) (2), this section shall apply only to that portion (if any) of the gain which is not greater than the excess of (i) that portion of the adjusted basis (adjusted for any adjustment required under the second sentence of section 334 (b) (2)) of the stock of the liquidating corporation which is allocable, under regulations prescribed by the Secretary or his delegate, to the property sold or exchanged, over (ii) the adjusted basis, in the hands of the liquidating corporation, of the property sold or exchanged.

§ 1.337–1 General.

Except as provided in sections 337(c) and 392(b), if a corporation distributes all of its assets in complete liquidation within 12 months after the adoption of a plan of liquidation, which plan must be adopted on or after June 22, 1954, no gain or loss shall be recognized from the sale of property (as defined in section 337(b)) during such 12-month period. For this purpose such sales may be made before the adoption of the plan of liquidation if made on the same day such plan is adopted. All assets (less assets retained to meet claims), both tangible and intangible, must be distributed within the 12-month period. Any assets retained after the expiration of the 12-month period for the payment of claims (including unascertained or contingent liabilities or expenses) must be specifically set apart for that purpose and must be reasonable in amount in relation to the items involved. The 12-month period shall begin on the date of adoption of the plan determined as provided in paragraph (b) of § 1.337–2 and no extension of such period can be granted. See section 453(d)(4)(B) relative to nonrecognition of gain on the distribution of certain installment obligations. Sales or exchanges made by a collapsible corporation (as defined in section 341 (b)) are excluded from the operation of section 337 by section 337 (c). Accordingly, section 337 does not apply to any sale or exchange of property whenever the distribution of such property in partial or complete liquidation to the shareholders in lieu of such sale or exchange would have resulted in the taxation of the gain from such distribution in the manner provided in section 341 (a) as to any shareholder or would have resulted in the taxation of the gain in such manner, but for the application of section 341 (d). Likewise, section 337 does not apply to sales or exchanges made by a corporation if such corporation is liquidated in a transaction to which section 333 is applicable, or in a transaction to which section 332 applies (except to the extent provided in section 337 (c) (2) (B)). Section 392 (b) provides special rules with respect to the recognition of gain or loss upon certain sales made by a liquidating corporation during 1954 and 1955.

§ 1.337–2 Sales or exchanges within the scope of section 337.

(a) Provided the other conditions of section 337 are met, sales or exchanges which occur on or after the date on which the plan of complete liquidation is adopted and within the 12-month period thereafter are subject to the provisions of such section. The date on which a sale occurs depends primarily upon the intent of the parties to be gathered from the terms of the contract and the surrounding circumstances. In ascertaining whether a sale or exchange occurs on or after the date on which the plan of complete liquidation is adopted, the fact that negotiations for sale may have been commenced, either by the corporation or its shareholders, or both shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale. Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession of the property have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional.

(b) Ordinarily the date of the adoption of a plan of complete liquidation by a corporation is the date of adoption by the shareholders of the resolution authorizing the distribution of all the assets of the corporation (other than those retained to meet claims) in redemption of all of its stock. Where the corporation sells substantially all of its property of the type defined in section 337 (b) prior to the date of adoption by the shareholders of such resolution, then the date of the adoption of the plan of complete liquidation by such corporation is the date of the adoption by the shareholders of such resolution and gain or loss will be recognized with respect to such sales. Where no substantial part of the property of the type defined in section 337 (b) has been sold by the corporation prior to the date of adoption by the shareholders of such resolution, the date of the adoption of the plan of complete liquidation by such corporation is the date of adoption by the shareholders of such resolution and no gain or loss will be recognized on sales of such property on or after such date, if all the corporate assets (other than those retained to meet claims) are distributed in liquidation to the shareholders within 12 months after the date of the adoption of such resolution. In all other cases the date of the adoption of the plan of liquidation shall be determined from all the facts and circum-

stances. Section 337 shall not apply in any case in which all of the corporate assets (other than those retained to meet claims) are not distributed to the shareholders within 12 months after the date of the adoption of a resolution by the shareholders authorizing the distribution of all the corporate assets in redemption of all the corporate stock. A corporation will be considered to have distributed all of its property other than assets retained to meet claims even though it has retained an amount of cash equal to its known liabilities and liquidating expenses plus an amount of cash set aside under arrangements for the payment after the close of the 12-month period of unascertained or contingent liabilities and contingent expenses. Such arrangements for payment must be made in good faith, the amount set aside must be reasonable, and no amount may be set aside to meet claims of shareholders with respect to their stock. If it is established to the satisfaction of the Commissioner that there are shareholders who cannot be located, a distribution in liquidation includes a transfer to a State official, trustee, or other person authorized by law to receive distributions for the benefit of such shareholders. For the purposes of this paragraph "property of the type defined in section 337 (b)" means property upon the sale of which section 337 (a) may provide for the nonrecognition of gain or loss upon sale or exchange during a 12-month period, including property described in subparagraph (A) of section 337 (b) (1) if sold or exchanged at any time under the conditions set forth in section 337 (b) (2) and including installment obligations acquired in respect of such sale or exchange.

§ 1.337–3 Property defined.

(a) Except as provided in section 337(b)(2) and this section, the term "property" as used in section 337(a) and § 1.337–1 does not include, (1) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business (hereinafter for purposes of section 337 referred to as "inventory"), (2) installment obligations acquired at any time from the sale or exchange of inventory, or (3) installment obligations acquired from the sale or exchange of property (other than inventory) prior to the adoption of the plan of liquidation. With the exceptions listed in this paragraph, the term "property" includes all assets owned by a corporation.

(b) Except as provided in paragraph (c) of this section, if substantially all of the inventory is sold or exchanged to one person in one transaction, then for the purpose of section 337 (a) the term "property" shall include:

(1) The inventory so sold or exchanged, and

(2) Installment obligations acquired in such sale or exchange.

For this purpose, the term "substantially all" means substantially all of the inventory at the time of the sale and includes inventory subject to liabilities, specific or otherwise. Section 337 (b) (2) shall be inapplicable if the inventory so sold is replaced by like inventory, or by a new kind of inventory.

(c) The term "property" in the case of a corporation which is engaged in two or more distinct businesses shall include the inventory of any one of such trades or businesses if substantially all of the inventory attributable to such trade or business is sold or exchanged to one person in one transaction. If installment obligations are received upon such a sale, such obligations are also included within the meaning of the term "property".

(d) This section may be illustrated by the following examples:

Example (1). Corporation A operates a grocery store at one location and a hardware store at another. Neither store handles items similar to those handled by the other. Both stores are served by a common warehouse. Pursuant to a plan of liquidation adopted by the corporation, the grocery store and all of its inventory, including that part of its inventory held in the warehouse, are sold to one person in one transaction. Thereafter, and within 12 months after the adoption of the plan of liquidation, all of the assets of the corporation are distributed to the shareholders. No gain or loss will be recognized upon the sale of all of the assets attributable to the grocery business, including the inventory items.

Example (2). Corporation B operates two department stores, one in the downtown business district and the other in a suburban shopping center. Both handle the same items and are served by a common warehouse which contains an amount of inventory items equal to the total of that in both stores. The part of the inventory in the warehouse which is attributable to each store cannot be clearly determined. Pursuant to a plan of liquidation adopted by the corporation, the assets of the suburban store, including the inventory held in such store, but not including any portion of the inventory held in the warehouse, are sold to one person in one transaction. Thereafter, and within 12 months after the adoption of the plan of liquidation, all of the assets of the corporation are distributed to the shareholders. No gain or loss will be recognized with respect to the sale of the property other than the inventory, but gain or loss will be recognized upon the sale of the inventory.

Example (3). The facts are the same as in example (2) except that the part of the inventory in the warehouse which is attributable to the suburban store can be clearly determined and both the inventory held in the store and that part of the inventory in the warehouse attributable to such store are sold. No gain or loss will be recognized upon the sale of the inventory.

§ 1.337–4 Limitation of gain.

(a) Section 337(c)(2)(B) provides a limitation upon the amount of gain not recognized where a corporation sells or exchanges property pursuant to a plan of complete liquidation (and such property, if distributed, would take the basis of the stock held by the distributee pursuant to the provisions of section 334 (b) (2) (relating to plans of liquidation adopted within 2 years after purchase of the stock)). The amount of gain not recognized shall not be greater than the excess of (1) that portion of the adjusted basis (further adjusted as provided in the second sentence of section 334(b)(2) and in paragraph (c) of § 1.334–1) of the stock of the liquidating corporation in the hands of its parent corporation allocable to the property sold or exchanged over (2) the adjusted basis of such property in the hands of the liquidating corporation.

(b) Paragraph (a) of this section may be illustrated by the following example:

Example. Corporation A owns more than 80 percent of the stock of Corporation B, which it purchased for $10,000. All of the assets of Corporation B, having a total basis of $4,000 are sold for $12,000. The portion of the realized gain of $8,000 which is not recognized is $6,000, computed as follows:

Basis of stock allocable to property sold	$10,000
Basis of property sold	4,000
Excess (not recognized)	6,000

In general, where section 337 (c) (2) (B) is applicable and where the gain realized from the sale of property is greater than the excess of the selling price of the property over the basis of the stock allocable to the property sold, the amount of gain to be recognized from such sale is equal to such excess. In the above example, the $2,000 gain representing the excess of the selling price of $12,000 over the basis of the stock allocable to the property sold ($10,000) would be recognized to the liquidating corporation.

(c) For the purpose of this section only, the basis (adjusted as described in paragraph (a) of this section) of the liquidating corporation's stock in the hands of its parent corporation on the date of the first sale of property, shall be allocated to the assets of the liquidating corporation (unreduced by any amount applicable to minority interests) on the basis of the fair market value of such assets (see paragraph (c) of § 1.334–1), both tangible and intangible, on the date the first property is sold by the liquidating corporation. The allocation then made shall remain unchanged for the purpose of determining recognized gain upon subsequent sales of property by the liquidating corporation unless the stock ownership of the parent corporation changes. In the event of such a change, a new allocation shall be made at the time of the next sale of property thereafter. The new allocation shall be made on the basis of the fair market value of the liquidating corporation's assets on the date of such sale.

§ 1.337–5 Information to be filed with return.

There must be attached to the return of the liquidating corporation the following information:

(a) A copy of the minutes of the stockholders' meeting at which the plan of liquidation was formally adopted, including a copy of the plan of liquidation.

(b) A statement of the assets sold after the adoption of the plan of liquidation including the dates of such sales. If section 337 (c) (2) (B), relating to limited nonrecognition of gain on sales by subsidiaries, is applicable, this statement must include a computation of the total gain and of the gain not recognized under this section.

(c) Information as to the date of the final liquidating distribution.

(d) A statement of the assets, if any, retained to pay liabilities and the nature of the liabilities.

§ 1.338 Statutory provisions; effect on earnings and profits.

SEC. 338. *Effect on earnings and profits.* For special rule relating to the effect on earnings and profits of certain distributions in partial liquidation, see section 312 (e).

COLLAPSIBLE CORPORATIONS; FOREIGN PERSONAL HOLDING COMPANIES

§ 1.341 Statutory provisions; collapsible corporations.

SEC. 341. *Collapsible corporations*—(a) *Treatment of gain to shareholders.* Gain from—

(1) The sale or exchange of stock of a collapsible corporation,

(2) A distribution in partial or complete liquidation of a collapsible corporation, which distribution is treated under this part as in part or full payment in exchange for stock, and

(3) A distribution made by a collapsible corporation which, under section 301 (c) (3) (A), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, to the extent that it would be considered (but for the provisions of this section) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in subsection (d), be considered as gain from the sale or exchange of property which is not a capital asset.

(b) *Definitions*—(1) *Collapsible corporation.* For purposes of this section, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to—

(A) The sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

(B) The realization by such shareholders of gain attributable to such property.

(2) *Production or purchase of property.* For purposes of paragraph (1), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if—

(A) It engaged in the manufacture, construction, or production of such property to any extent,

(B) It holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

(C) It holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation.

(3) *Section 341 assets.* For purposes of this section, the term "section 341 assets" means property held for a period of less than 3 years which is—

(A) Stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year;

(B) Property held by the corporation primarily for sale to customers in the ordinary course of its trade or business;

(C) Unrealized receivables or fees, except receivables from sales of property other than property described in this paragraph; or

(D) Property described in section 1231 (b) (without regard to any holding period therein provided), except such property which is or has been used in connection with the manufacture, construction, production, or sale of property described in subparagraph (A) or (B).

In determining whether the 3-year holding period specified in this paragraph has been satisfied, section 1223 shall apply, but no such period shall be deemed to begin before the completion of the manufacture, construction, production, or purchase.

(4) *Unrealized receivables.* For purposes of paragraph (3) (C), the term "unrealized receivables or fees" means, to the extent not previously includible in income under the method of accounting used by the corporation, any rights (contractual or otherwise) to payment for—

(A) Goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(B) Services rendered or to be rendered.

(c) *Presumption in certain cases*—(1) *In general.* For purposes of this section, a corporation shall, unless shown to the contrary, be deemed to be a collapsible corporation if (at the time of the sale or exchange, or the distribution, described in subsection (a)) the fair market value of its section 341 assets (as defined in subsection (b) (3)) is—

(A) 50 percent or more of the fair market value of its total assets, and

(B) 120 percent or more of the adjusted basis of such section 341 assets.

Absence of the conditions described in subparagraphs (A) and (B) shall not give rise to a presumption that the corporation was not a collapsible corporation.

(2) *Determination of total assets.* In determining the fair market value of the total assets of a corporation for purposes of paragraph (1) (A), there shall not be taken into account—

(A) Cash,

(B) Obligations which are capital assets in the hands of the corporation (and governmental obligations described in section 1221 (5)), and

(C) Stock in any other corporation.

(d) *Limitations on application of section.* In the case of gain realized by a shareholder with respect to his stock in a collapsible corporation, this section shall not apply—

(1) Unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (b) (3) or at any time thereafter, such shareholder (A) owned (or was considered as owing) more than 5 percent in value of the outstanding stock of the corporation, or (B) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 5 percent in value of the outstanding stock of the corporation;

(2) To the gain recognized during a taxable year, unless more than 70 percent of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(3) To gain realized after the expiration of 3 years following the completion of such manufacture, construction, production, or purchase.

For purposes of paragraph (1), the ownership of stock shall be determined in accordance with the rules prescribed in paragraphs (1), (2), (3), (5), and (6) of section 544 (a) (relating to personal holding companies); except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

§ 1.341–1 Collapsible corporations; in general.

Subject to the limitations contained in § 1.341–4, the entire gain from (a) the actual sale or exchange of stock of a collapsible corporation, (b) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 331, as payment in exchange for stock, and (c) a distribution made by a collapsible corporation which, under section 301 (c) (3), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

§ 1.341–2 Definitions.

(a) *Determination of collapsible corporation.* (1) A collapsible corporation is defined by section 341(b)(1) to be a corporation formed or availed of principally (i) for the manufacture, construction, or production of property, (ii) for the purchase of property which (in the hands of the corporation) is property described in section 341(b)(3), or (iii) for the holding of stock in a corporation so formed or availed of, with a view to (*a*) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and (*b*) the realization by such shareholders of gain attributable to such property. See § 1.341–5 for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of this section. See paragraph (d) of § 1.341–5 for examples of the application of section 341.

(2) Under section 341 (b) (1) the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated, unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view. Any gain of such a shareholder on his

stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 341 (b).

(3) A corporation is formed or availed of with a view to the action described in section 341 (b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

(4) The property referred to in section 341 (b) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 341 (b) there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the taxable income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

(5) A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (i) engaged in the manufacture, construction, or production of property to any extent, or (ii) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (iii) holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under subdivision (i) of this subparagraph, for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under subdivision (ii) of this subparagraph, for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 351, then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 362 be determined by reference to the basis of the property in the hands of the individual. Under subdivision (iii) of this subparagraph, for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 1031 (a), then the corporation would be deemed to have constructed the property received by it in the exchange, since the basis of the property received by it in the exchange would, under section 1031 (d), be determined by reference to the basis of the property constructed by the corporation.

(6) In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 341 (b) (3). The determination whether property is of a kind described in section 341 (b) (3) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 341 (b) (1).

(7) Section 341 is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(b) *Section 341 assets.* For the purposes of this section, the term "section 341 assets" means the following listed property if held for less than 3 years:

(1) Stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.

(2) Property held primarily for sale to customers in the ordinary course of a trade or business.

(3) Property used in a trade or business as defined in section 1231 (b) and held for less than 3 years, except property that is or has been used in connection with the manufacture, construction, production or sale of property described in subparagraphs (1) and (2) of this paragraph.

(4) Unrealized receivables or fees pertaining to property listed in this paragraph. The term "unrealized receivables or fees" means any rights (contractual or otherwise) to payment for property listed in subparagraphs (1), (2), and (3) of this paragraph which has been delivered or is to be delivered and rights to payments for services rendered or to be rendered, to the extent such rights have not been included in the income of the corporation under the method of accounting used by it. In determining whether the assets referred to in this paragraph have been held for 3 years, the time such assets were held by a transferor shall be taken into consideration (section 1223). However, no such period shall begin before the date the manufacture, construction, production, or purchase of such assets is completed.

§ 1.341–3 Presumptions.

(a) Unless shown to the contrary a corporation shall be considered to be a collapsible corporation if at the time of the transactions described in § 1.134–1 the fair market value of the section 341 assets held by it constitutes 50 percent or more of the fair market value of its total assets and the fair market value of the section 341 assets is 120 percent or more of the adjusted basis of such assets. In determining the fair market value of the total assets, cash, obligations which are capital assets in the hands of the corporation, governmental obligations, and stock in any other corporation shall not be taken into consideration. The failure of a corporation to meet the requirements of this paragraph, shall not give rise to the presumption that the corporation was not a collapsible corporation.

(b) The following example will illustrate the application of this section:

Example. A corporation, filing its income tax returns on the accrual basis, on July 31, 1955, owned assets with the following fair market values: Cash, $175,000; note receivable held for investment, $130,000; stocks of other corporations, $545,000; rents receivable, $15,000; and a building constructed by the corporation in 1953 and held thereafter as rental property, $750,000. The adjusted basis of the building on that date was $600,000. The only debt outstanding was a $500,000 mortgage on the building. On July 31, 1955, the corporation liquidated and distributed all of its assets to its shareholders. In computing whether the fair market value of the section 341 assets (only the building) is 50 percent or more of the fair market value of the total assets, the cash, note receivable, and stocks of other corporations are not taken into account in determining the value of the total assets, with the result that the fair market value of the total assets was $765,000 ($750,000 (building) plus $15,000 (rents receivable)). Therefore, the value of the building is 98 percent of the total assets ($750,000÷$765,000). The value of the building is also 125 percent of the adjusted basis of the building ($750,000÷$600,000). In view of the above facts, there arises a presumption that the corporation is a collapsible corporation.

§ 1.341–4 Limitations on application of section.

(a) *General.* This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than six months. Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he had held for six months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 341, that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than six months results in ordinary income rather than

long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

(b) *Stock ownership rules.* (1) This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in section 341 (b) (3) or at any time thereafter, (i) owned, or was considered as owning, more than 5 percent in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 5 percent in value of the outstanding stock of the corporation.

(2) The ownership of stock shall be determined in accordance with the rules prescribed by section 544 (a) (1), (2), (3), (5), and (6), except that, in addition to the persons prescribed by section 544 (a) (2), the family of an individual shall include the spouses of that individual's brothers and sisters, whether such brothers and sisters are by the whole or the half blood, and the spouses of that individual's lineal descendants.

(3) For the purpose of this limitation, treasury stock shall not be considered as outstanding stock.

(4) It is possible, under this limitation, that a shareholder in a collapsible corporation may have gain upon his stock in that corporation treated differently from the gain of another shareholder in the same collapsible corporation.

(c) *Seventy-percent rule.* (1) This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 341 (b) (1). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

(2) For the purpose of this limitation, the gain attributable to the property referred to in section 341(b(1) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 301 (c) (3) (A), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

(3) Gain may be attributable to the property referred to in section 341 (b) (1) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) The following example will illustrate the application of the 70 percent rule:

Example: On January 2, 1954, A formed the Z Corporation and contributed $1,000,000 cash in exchange for all of the stock thereof. The Z Corporation invested $400,000 in one project for the purpose of building and selling residential houses. As of December 31, 1954, the residential houses in this project were all sold, resulting in a profit of $100,000 (after taxes). Simultaneously with the development of the first project and in connection with a second and separate project the Z Corporation invested $600,000 in land for the purpose of subdividing such land into lots suitable for sale as home sites and distributing such lots in liquidation before the realization by the corporation of a substantial part of the taxable income to be realized from this second project. As of December 31, 1954, Corporation Z had derived $60,000 in profits (after taxes) from the sale of some of the lots. On January 2, 1955, the Z Corporation made a distribution in complete liquidation to shareholder A who received:

(i) $560,000 in cash and notes, and

(ii) Lots having a fair market value of $940,000.

The gain recognized to shareholder A upon the liquidation is $500,000 ($1,500,000 minus $1,000,000). The gain which would have been recognized to A if the second project had not been undertaken is $100,000 ($1,100,000 minus $1,000,000). Therefore, the gain attributable to the second project which is property referred to in section 341 (b) (1), is $400,000 ($500,000 minus $100,000). Since this gain ($400,000) is more than 70 percent of the entire gain ($500,000) recognized to A on the liquidation, the entire gain so recognized is gain subject to section 341 (a).

(d) *Three-year rule.* This section shall not apply to that portion of the gain of a shareholder that is realized more than three years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable.

§ 1.341–5 Application of section.

(a) Whether or not a corporation is a collapsible corporation shall be determined under the regulations of §§ 1.341–2 and 1.341–3 on the basis of all the facts and circumstances in each particular case. The following paragraphs of this section set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs of this section are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (b) of this section, but not the facts in paragraph (c) of this section, are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the regulations of §§ 1.341–2 and 1.341–3 are not satisfied. Similarly, if the facts in paragraph (c) of this section are present, the corporation may nevertheless be a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in §§ 1.341–2 and 1.341–3 or if the facts in paragraph (c) of this section are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property. See § 1.341–4 for provisions which make section 341 inapplicable to certain shareholders of collapsible corporations.

(b) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (a) of this section and paragraph (c) of this section) to establish that a corporation is a collapsible corporation:

(1) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 301 (c) (3) (A),

(2) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described in subparagraphs (4) and (5) of this paragraph, and

(3) At the time of the manufacture, construction, production, or purchase of the property described in subparagraphs (4) and (5) of this paragraph, such activity was substantially in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to in subparagraphs (2) and (3) of this paragraph is that property or the aggregate of those properties which meet the following two requirements:

(4) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the corporation holding such property) is property described in section 341 (b) (3), and

(5) At the time of the sale, exchange, or distribution described in subparagraph (1) of this paragraph, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the taxable income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this subparagraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this subparagraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(c) The absence of any of the facts set forth in paragraph (b) of this section

or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (a) of this section) to establish that a corporation is not a collapsible corporation:

(1) In the case of a corporation subject to paragraph (b) of this section only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 341 (b) (3) (A) and (B), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(i) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(ii) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(2) In the case of a corporation subject to paragraph (b) of this section with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized taxable income from such property is not substantial in relation to the amount of the taxable income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (b) (1) of this section) from such property and from other property manufactured, constructed, or produced by the corporation.

(d) The following examples will illustrate the application of this section:

Example (1). (i) On January 2, 1954, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1954. On December 31, 1954, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable State law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1954, the corporation has not realized any earnings and profits. In 1955, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

(ii) Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the taxable income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under paragraph (b) of § 1.341–5. The provisions of section 341 (d) do not prohibit the application of section 341 (a). Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 341, will be considered ordinary income under section 341 (a).

(iii) In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See § 1.342–2 and paragraph (a) of § 1.341–5.

Example (2). (i) On January 2, 1954, B formed X Corporation and became its sole shareholder. In August 1954, the corporation completed construction of an office building. It immediately sold this building at a gain of $50,000, included this entire gain in its return for 1954, and distributed this entire gain (less taxes) to B. In June 1955, the corporation completed construction of a second office building. In August 1955, B sold the entire stock of X Corporation at a gain of $12,000, which gain is attributable to the second building.

(ii) X Corporation is a collapsible corporation under section 341 (b) for the following reasons: The gain realized through the sale of the stock of X Corporation was attributable to the second office building; the construction of that building was a substantial activity of X Corporation during the time of construction and, at the time of sale, the corporation had not realized a substantial part of the taxable income to be derived from such building. Since the provisions of section 341 (d) do not prohibit the application of section 341 (a) to B, the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts are the same as in example (2), except that the following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involving the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See § 1.341–2 and paragraph (a) of § 1.341–5.

Example (4). (i) On January 2, 1948, C formed the Y Corporation and became the sole shareholder thereof. The Y Corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition. On January 2, 1955, C sold all of the stock of the Y Corporation at a gain. The Y Corporation has produced one motion picture each year since its organization and before January 2, 1955, it has realized a substantial part of the taxable income to be derived from each of its motion pictures except the last one made in 1954. This last motion picture was completed September 1, 1954. As of January 2, 1955, no license had been made for its exhibition. The fair market value on January 2, 1955, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1954, and between that date and January 2, 1955, the corporation had realized taxable income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its taxable income when received (after adjustment for taxes).

(ii) Although the corporation is within paragraph (b) of this section with respect to the production of property, the amount of the unrealized income from such property ($50,000) is not substantial in relation to the amount of the income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y Corporation is within paragraph (c) (2) of this section, and is not considered a collapsible corporation.

Example (5). The facts are the same as in example (4) except that C sold all of his stock to D on February 1, 1954. On January 2, 1955, D sold all of the Y Corporation stock at a gain, the gain being attributable to the picture completed September 1, 1954, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of paragraph (c) (2) of this section are not significant at the time of the sale by D, and the Y Corporation would be considered a collapsible corporation on January 2, 1955. See § 1.341–2 and paragraph (a) of § 1.341–5.

§ 1.342 Statutory provisions; liquidation of certain foreign personal holding companies.

SEC. 342. *Liquidation of certain foreign personal holding companies*—(a) *In general.* If any distribution—

(1) Is, within the meaning of the Internal Revenue Code of 1939, a distribution in partial liquidation or in complete liquidation (including any one of a series of distributions made by the corporation in complete cancellation or redemption of all its stock) and

(2) Is made by a foreign corporation which, with respect to any taxable year beginning on or before, and ending after, August 26, 1937, was a foreign personal holding company, and with respect to which a United States group (as defined in section 552 (a) (2)) existed after August 26, 1937, and before January 1, 1938,

then the distribution shall be treated as a distribution in full or part payment in exchange for the stock, and the amount of the gain recognized (determined under section 1002 without regard to this part) resulting from such distribution shall be considered as a gain from the sale or exchange of a capital asset held for not more than 6 months.

(b) *Special rule for certain liquidations before 1956.* Subsection (a) shall not apply in the case of a series of distributions in complete liquidation described in subsection (a) if—

(1) The first distribution is made on or after June 22, 1954, and

(2) The final distribution is made before January 1, 1956;

and the amount of the gain recognized (determined under section 1002 without regard to this part) resulting from such distributions shall be considered as a gain from the sale or exchange of a capital asset, or of property which is not a capital asset, as the case may be.

§ 1.342–1 General.

The determination of whether a foreign corporation was a foreign personal holding company with respect to a taxable year beginning on or before, and ending after August 26, 1937, shall be made under section 331 of the Revenue Act of 1936 (50 Stat. 818) and the regulations thereunder. For the purpose of section 342 (a), a liquidation may be completed before the actual dissolution of the liquidating corporation. However, no liquidation shall be considered as completed until the liquidating corporation and the receiver (or

trustees in liquidation) are finally divested of all the property, whether tangible or intangible.

DEFINITION

§ 1.346 Statutory provisions; partial liquidation defined.

SEC. 346. *Partial liquidation defined*—(a) *In general.* For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if —

(1) The distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) The distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562 (b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) *Termination of a business.* A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

(c) *Treatment of certain redemptions.* The fact that, with respect to a shareholder, a distribution qualifies under section 302 (a) (relating to redemptions treated as distributions in part or full payment in exchange for stock) by reason of section 302 (b) shall not be taken into account in determining whether the distribution, with respect to such shareholder, is also a distribution in partial liquidation of the corporation.

§ 1.346–1 Partial liquidation.

(a) *General.* This section defines a partial liquidation. If amounts are distributed in partial liquidation such amounts are treated under section 331(a)(2) as received in part or full payment in exchange for the stock. A distribution is treated as in partial liquidation of a corporation if:

(1) The distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan of complete liquidation, or

(2) The distribution:

(i) Is not essentially equivalent to a dividend,

(ii) Is in redemption of a part of the stock of the corporation pursuant to a plan, and

(iii) Occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

An example of a distribution which will qualify as a partial liquidation under subparagraph (2) of this paragraph and section 346 (a) is a distribution resulting from a genuine contraction of the corporate business such as the distribution of unused insurance proceeds recovered as a result of a fire which destroyed part of the business causing a cessation of a part of its activities. On the other hand, the distribution of funds attributable to a reserve for an expansion program which has been abandoned does not qualify as a partial liquidation within the meaning of section 346 (a). A distribution to which section 355 applies (or so much of section 356 as relates to section 355) is not a distribution in partial liquidation within the meaning of section 346 (a).

(b) *Special requirements on termination of business.* A distribution which occurs within the taxable year in which the plan is adopted or within the succeeding taxable year and which meets the requirements of subsection (b) of section 346 falls within paragraph (a)(2) of this section and within section 346 (a) (2). The requirements which a distribution must meet to fall within subsection (b) of section 346 are:

(1) Such distribution is attributable to the corporation's ceasing to conduct, or consists of assets of, a trade or business which has been actively conducted throughout the five-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part, and

(2) Immediately after such distribution by the corporation it is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the five-year period ending on the date of such distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

A distribution shall be treated as having been made in partial liquidation pursuant to section 346 (b) if it consists of the proceeds of the sale of the assets of a trade or business which has been actively conducted for the five-year period and has been terminated, or if it is a distribution in kind of the assets of such a business, or if it is a distribution in kind of some of the assets of such a business and of the proceeds of the sale of the remainder of the assets of such a business. In general, a distribution which will qualify under section 346 (b) may consist of, but is not limited to:

(i) Assets (other than inventory or property described in subdivision (ii) of this subparagraph) used in the trade or business throughout the five-year period immediately before the distribution (for this purpose an asset shall be considered used in the trade or business during the period of time the asset which it replaced was so used), or

(ii) Proceeds from the sale of assets described in subdivision (i) of this subparagraph, and, in addition,

(iii) The inventory of such trade or business or property held primarily for sale to customers in the ordinary course of business, if:

(*a*) The items constituting such inventory or such property were substantially similar to the items constituting such inventory or property during the five-year period immediately before the distribution, and

(*b*) The quantity of such items on the date of distribution was not substantially in excess of the quantity of similar items regularly on hand in the conduct of such business during such five-year period,

or

(iv) Proceeds from the sale of inventory or property described in subdivision (iii) of this subparagraph, if such inventory or property is sold in bulk in the course of termination of such trade or business and if with respect to such inventory the conditions of subdivision (iii) (*a*) and (*b*) of this subparagraph would have been met had such inventory or property been distributed on the date of such sale.

(c) *Active conduct of a trade or business.* For the purpose of section 346 (b) (1), a corporation shall be deemed to have actively conducted a trade or business immediately before the distribution, if:

(1) In the case of a business the assets of which have been distributed in kind, the business was operated by such corporation until the date of distribution, or

(2) In the case of a business the proceeds of the sale of the assets of which are distributed, such business was actively conducted until the date of sale and the proceeds of such sale were distributed as soon thereafter as reasonably possible.

The term "active conduct of a trade or business" shall have the same meaning in this section as in paragraph (c) of § 1.355–1.

§ 1.346–2 Treatment of certain redemptions.

If a distribution in a redemption of stock qualifies as a distribution in part or full payment in exchange for the stock under both section 302(a) and this section, then only this section shall be applicable. None of the limitations of section 302 shall be applicable to such redemption.

§ 1.346–3 Effect of certain sales.

The determination of whether assets sold in connection with a partial liquidation are sold by the distributing corporation or by the shareholder is a question of fact to be determined under the facts and circumstances of each case.

CORPORATE ORGANIZATIONS AND REORGANIZATIONS

CORPORATE ORGANIZATIONS

§ 1.351 Statutory provisions; transfer to corporation controlled by transferor.

SEC. 351. *Transfer to corporation controlled by transferor*—(a) *General rule.* No gain or loss shall be recognized if property

is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) *Receipt of property.* If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) Gain (if any) to such recipient shall be recognized, but not in excess of—

(A) The amount of money received, plus

(B) The fair market value of such other property received; and

(2) No loss to such recipient shall be recognized.

(c) *Special rule.* In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) *Cross references.* (1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.

(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61 (a) (1).

§ 1.351–1 Transfer to corporation controlled by transferor.

(a) (1) Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation, if immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see section 7701(a)(1)). To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368 (c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this section—

(i) Stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and

(ii) Stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

For the purpose of section 351, stock rights or stock warrants are not included in the term "stock or securities."

(2) The application of section 351 (a) is illustrated by the following examples:

Example (1). C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example (2). B owns certain real estate which cost him $50,000 in 1930, but which has a fair market value of $200,000 in 1955. He transfers the property to the N Corporation in 1955 for 78 percent of each class of stock of the corporation having a fair market value of $200,000, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1940 to other persons for cash. B realized a taxable gain of $150,000 on this transaction.

Example (3). E, an individual, owns property with a basis of $10,000 but which has a fair market value of $18,000. E also had rendered services valued at $2,000 to Corporation F. Corporation F has outstanding 100 shares of common stock all of which are held by G. Corporation F issues 400 shares of its common stock (having a fair market value of $20,000) to E in exchange for his property worth $18,000 and in compensation for the services he has rendered worth $2,000. Since immediately after the transaction, E owns 80 percent of the outstanding stock of Corporation F, no gain is recognized upon the exchange of the property for the stock. However, E realized $2,000 of ordinary income as compensation for services rendered to Corporation F.

(b) (1) Where property is transferred to a corporation by two or more persons in exchange for stock or securities, as described in paragraph (a) of this section, it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts (section 2501 and following), to pay compensation (section 61 (a) (1)), or to satisfy obligations of the transferor of any kind.

(2) The application of paragraph (b) (1) of this section may be illustrated as follows:

Example (1). Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth $8,000 in exchange for 20 shares of stock, and B transfers property worth $2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. However, if it is determined that A in fact made a gift to B, such gift will be subject to tax under section 2501 and following. Similarly, if B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportion in the amount of stock received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

Example (2). Individuals C and D each transferred, to a newly organized corporation, property having a fair market value of $4,500 in exchange for the issuance by the corporation of 45 shares of its capital stock to each transferor. At the same time, the corporation issued to E, an individual, 10 shares of its capital stock in payment for organizational and promotional services rendered by E for the benefit of the corporation. E transferred no property to the corporation. C and D were under no obligation to pay for E's services. No gain or loss is recognized to C or D. E received compensation taxable as ordinary income to the extent of the fair market value of the 10 shares of stock received by him.

§ 1.351–2 Receipt of property.

(a) If an exchange would be within the provisions of section 351(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.

(b) See section 357 and the regulations pertaining to that section for applicable rules as to the treatment of liabilities as "other property" in cases subject to section 351, where another party to the exchange assumes a liability, or acquires property subject to a liability.

(c) See sections 358 and 362 and the regulations pertaining to those sections for applicable rules with respect to the determination of the basis of stock, securities, or other property received in exchanges subject to section 351.

(d) See part I (section 301 and following), subchapter C, chapter 1 of the Code, and the regulations thereunder for applicable rules with respect to the taxation of dividends where a distribution by a corporation of its stock or securities in connection with an exchange subject to section 351(a) has the effect of the distribution of a taxable dividend.

§ 1.351–3 Records to be kept and information to be filed.

(a) Every person who received the stock or securities of a controlled corporation, or other property as part of the consideration, in exchange for property under section 351, shall file with his

income tax return for the taxable year in which the exchange is consummated a complete statement of all facts pertinent to such exchange, including—

(1) A description of the property transferred, or of his interest in such property, together with a statement of the cost or other basis thereof, adjusted to the date of transfer.

(2) With respect to stock of the controlled corporation received in the exchange, a statement of—

(i) The kind of stock and preferences, if any;

(ii) The number of shares of each class received; and

(iii) The fair market value per share of each class at the date of the exchange.

(3) With respect to securities of the controlled corporation received in the exchange, a statement of—

(i) The principal amount and terms; and

(ii) The fair market value at the date of exchange.

(4) The amount of money received, if any.

(5) With respect to other property received—

(i) A complete description of each separate item;

(ii) The fair market value of each separate item at the date of exchange; and

(iii) In the case of a corporate shareholder, the adjusted basis of the other property in the hands of the controlled corporation immediately before the distribution of such other property to the corporate shareholder in connection with the exchange.

(6) With respect to liabilities of the transferors assumed by the controlled corporation, a statement of—

(i) The nature of the liabilities;

(ii) When and under what circumstances created;

(iii) The corporate business reason for assumption by the controlled corporation; and

(iv) Whether such assumption eliminates the transferor's primary liability.

(b) Every such controlled corporation shall file with its income tax return for the taxable year in which the exchange is consummated—

(1) A complete description of all the property received from the transferors.

(2) A statement of the cost or other basis thereof in the hands of the transferors adjusted to the date of transfer.

(3) The following information with respect to the capital stock of the controlled corporation—

(i) The total issued and outstanding capital stock immediately prior to and immediately after the exchange, with a complete description of each class of stock;

(ii) The classes of stock and number of shares issued to each transferor in the exchange, and the number of shares of each class of stock owned by each transferor immediately prior to and immediately after the exchange, and

(iii) The fair market value of the capital stock as of the date of exchange which was issued to each transferor.

(4) The following information with respect to securities of the controlled corporation—

(i) The principal amount and terms of all securities outstanding immediately prior to and immediately after the exchange,

(ii) The principal amount and terms of securities issued to each transferor in the exchange, with a statement showing each transferor's holdings of securities of the controlled corporation immediately prior to and immediately after the exchange,

(iii) The fair market value of the securities issued to the transferors on the date of the exchange, and

(iv) A statement as to whether the securities issued in the exchange are subordinated in any way to other claims against the controlled corporation.

(5) The amount of money, if any, which passed to each of the transferors in connection with the transaction.

(6) With respect to other property which passed to each transferor—

(i) A complete description of each separate item;

(ii) The fair market value of each separate item at the date of exchange, and

(iii) In the case of a corporate transferor, the adjusted basis of each separate item in the hands of the controlled corporation immediately before the distribution of such other property to the corporate transferor in connection with the exchange.

(7) The following information as to the transferor's liabilities assumed by the controlled corporation in the exchange—

(i) The amount and a description thereof,

(ii) When and under what circumstances created, and

(iii) The corporate business reason or reasons for assumption by the controlled corporation.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in the type of exchange described in section 351, showing the information listed above, in order to facilitate the determination of gain or loss from a subsequent disposition of stock or securities and other property, if any, received in the exchange.

EFFECTS ON SHAREHOLDERS AND SECURITY HOLDERS

§ 1.354 Statutory provisions; exchanges of stock and securities in certain reorganizations.

SEC. 354. *Exchanges of stock and securities in certain reorganizations*—(a) *General rule*—(1) *In general.* No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) *Limitation.* Paragraph (1) shall not apply if—

(A) The principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) Any such securities are received and no such securities are surrendered.

(3) *Cross reference.* For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) *Exception*—(1) *In general.* Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) The corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) The stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) *Cross reference.* For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of section 368 (a) (1) (D), see section 355.

(c) *Certain railroad reorganizations.* Notwithstanding any other provision of this subchapter, subsection (a) (1) (and so much of section 356 as relates to this section) shall apply with respect to a plan of reorganization (whether or not a reorganization within the meaning of section 368 (a)) for a railroad approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act, or under section 20b of the Interstate Commerce Act, as being in the public interest.

§ 1.354–1 Exchanges of stock and securities in certain reorganizations.

(a) Section 354 provides that under certain circumstances no gain or loss is recognized to a shareholder who surrenders his stock in exchange for other stock or to a security holder who surrenders his securities in exchange for stock. Section 354 also provides that under certain circumstances a security holder may surrender securities and receive securities in the same principal amount or in a lesser principal amount without the recognition of gain or loss to him. The exchanges to which section 354 applies must be pursuant to a plan of reorganization as provided in section 368 (a) and the stock and securities surrendered as well as the stock and securities received must be those of a corporation which is a party to the reorganization. Section 354 does not apply to exchanges pursuant to a reorganization described in section 368 (a) (1) (D) unless the transferor corporation—

(1) Transfers all or substantially all of its assets to a single corporation, and

(2) Distributes all of its remaining properties (if any) and the stock, securities and other properties received in the exchange to its shareholders or security holders in pursuance of the plan of reorganization. The fact that properties retained by the transferor corporation, or received in exchange for the properties transferred in the reorganization, are used to satisfy existing liabilities not represented by securities and which were incurred in the ordinary course of business before the reorganization does not prevent the application of section 354 to an exchange pursuant to a plan of reorganization defined in section 368 (a) (1) (D).

(b) Except in the case described in subsection (c), section 354 is not applicable to an exchange of stock or securities if a greater principal amount of securities is received than the principal amount of securities the recipient surrenders, or if securities are received and the recipient surrenders no securities. See, however, section 356 and regulations

pertaining to such section. See also section 306 with respect to the receipt of preferred stock in a transaction to which section 354 is applicable.

(c) An exchange of stock or securities shall be subject to section 354 (a) (1) even though—

(1) Such exchange is not pursuant to a plan of reorganization described in section 368 (a), and

(2) The principal amount of the securities received exceeds the principal amount of the securities surrendered or if securities are received and no securities are surrendered—

if such exchange is pursuant to a plan of reorganization for a railroad corporation as defined in section 77 (m) of the Bankruptcy Act (11 U.S.C. 205(m)) and is approved by the Interstate Commerce Commission under section 77 of such act or under section 20b of the Interstate Commerce Act (49 U.S.C. 20b) as being in the public interest. Section 354 is not applicable to such exchanges if there is received property other than stock or securities. See, however, section 356 and regulations pertaining to such section.

(d) The rules of section 354 may be illustrated by the following examples:

Example (1). Pursuant to a reorganization under section 368 (a) to which Corporations T and W are parties, A, a shareholder in Corporation T, surrenders all his common stock in Corporation T in exchange for common stock of Corporation W. No gain or loss is recognized to A.

Example (2). Pursuant to a reorganization under section 368 (a) to which Corporations X and Y (which are not railroad corporations) are parties, B, a shareholder in Corporation X, surrenders all his stock in X for stock and securities in Y. Section 354 does not apply to this exchange. See, however, section 356.

Example (3). C, a shareholder in Corporation Z (which is not a railroad corporation), surrenders all his stock in Corporation Z in exchange for securities in Corporation Z. Whether or not this exchange is in connection with a recapitalization under section 368 (a) (1) (E), section 354 does not apply. See, however, section 302.

(e) For the purpose of section 354, stock rights or stock warrants are not included in the term "stock or securities".

§ 1.355 Statutory provisions; distribution of stock and securities of a controlled corporation.

SEC. 355. *Distribution of stock and securities of a controlled corporation*—(a) *Effect on distributees*—(1) *General rule.* If—

(A) A corporation (referred to in this section as the "distributing corporation")—

(i) Distributes to a shareholder, with respect to its stock, or

(ii) Distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) The transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) The requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) As part of the distribution, the distributing corporation distributes—

(i) All of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) An amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) *Non pro rata distributions, etc.* Paragraph (1) shall be applied without regard to the following:

(A) Whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation.

(B) Whether or not the shareholder surrenders stock in the distributing corporation, and

(C) Whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a) (1) (D)).

(3) *Limitation.* Paragraph (1) shall not apply if—

(A) The principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) Securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) *Cross reference.* For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) *Requirements as to active business*—(1) *In general.* Subsection (a) shall apply only if either—

(A) The distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) Immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.* For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) It is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) Such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) Such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) Control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) Was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) Was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

§ 1.355–1 Distribution of stock and securities of controlled corporation.

(a) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five years, and which, in general, have been owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business. For the purpose of section 355, stock rights or stock warrants are not included in the term "stock and securities".

(b) *Types of separations.* Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previously operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

(c) *Active business.* Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355 (b) (1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),

(2) The ownership and operation of land or buildings all or substantially all

of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

(d) *Examples.* The following examples illustrate the application of the rules described in paragraph (c) of this section:

Example (*1*). Corporation A is engaged in the manufacture and sale of soap and detergents and owns investment securities. It proposes to place the investment securities in a new corporation and distribute the stock of such new corporation to its shareholders. The holding of investment securities does not constitute a trade or business.

Example (*2*). Corporation B is engaged in the business of manufacturing and selling hats in its own factory building. It proposes to transfer the factory building to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in connection with the manufacturing of hats constitute a trade or business; but the operation of the factory building does not.

Example (*3*). Corporation C, a bank, owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors of which it rents to various tenants. The ten floors are rented, managed and maintained by the real estate department of the bank. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. The activities in connection with banking constitute a trade or business as do also the activities in connection with the rental of the building.

Example (*4*). Corporation D, a bank, owns a two-story building in a suburban area, the ground floor and approximately one-half of the second floor of which is occupied by it in the conduct of its banking business. The remainder of the second floor is rented as storage space to a neighboring retail merchant. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. With respect to the rental of part of the second floor of its building, the bank is not engaged in the active conduct of a trade or business, such activity being only incidental to its banking business.

Example (*5*). Corporation E is engaged in the manufacture and sale of wood products. In connection with such manufacturing, it maintains a research department for its own use. It proposes to transfer the research department to a new corporation after which it will engage the services of the new corporation on a contract basis. The activities of the research department do not constitute a trade or business.

Example (*6*). Corporation F owns and rents an office building and owns vacant land. It proposes to transfer the vacant land to a new corporation and distribute the stock of such new corporation to its shareholders. The holding of the vacant land does not constitute a trade or business.

Example (*7*). Corporation G owns land on which it engages in the ranching business. Oil has been discovered in the area and it is apparent that oil may be found under the land on which the ranching activities are maintained. Corporation G has engaged in no activities in connection with the mineral rights. It proposes to transfer the mineral rights to a new corporation and distribute the stock of such new corporation to shareholders. Corporation G is not engaged in an active trade or business with respect to the mineral rights.

Example (*8*). Corporation H manufactures and sells ice cream at a plant in State X and at a plant in State Y. Corporation H proposes to transfer the plant and related activities in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business.

Example (*9*). Corporation I manufactures and sells ice cream in State X. It purchases land and constructs a new plant in State Y. After manufacturing and selling operations have commenced at the new plant, it proposes to transfer it to a new corporation and distribute the stock of such new corporation to its shareholders. The activities at the new plant constitute a trade or business which, however, has been in existence only since such activities began.

Example (*10*). Corporation J has owned and operated a men's retail clothing store in the downtown area of the City of R for seven years and has also owned and operated a men's retail clothing store in the suburban area of the City of R for nine years. The manager of each store directs its operations and makes the necessary purchases. No common warehouse is maintained. Corporation J proposes to transfer the store building, fixtures, and inventory of the suburban store to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation J. The activities of each store constitute a trade or business which has been in existence for more than five years.

Example (*11*). Corporation K processes and sells meat products. It is proposed to separate the selling from the manufacturing activities by forming a separate corporation, L, to handle sales. Corporation K will transfer to Corporation L certain physical assets pertaining to the sales function plus cash for working capital in exchange for the capital stock of Corporation L which will be distributed to the shareholders of Corporation K. Since the manufacturing and selling operations constitute only one integrated business, neither Corporation K nor Corporation L will be continuing the active conduct of a trade or business formerly conducted by Corporation K.

Example (*12*). Corporation M is engaged in the manufacture and sale of steel and steel products. In addition, Corporation M owns and operates a coal mine for the sole purpose of supplying its coal requirements in the manufacture of steel. It is proposed to transfer the coal mine to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation M. The activities of Corporation M in connection with the operation of the coal mine do not constitute a trade or business, since such activities are not themselves independently producing income although a part of the business operated for profit.

Example (*13*). Corporation N manufactures steel containers for oil and oil products at a plant in State X and at a plant in State Y. Pursuant to a sales contract with Corporation O, Corporation N sells its entire product to Corporation O. Corporation N proposes to transfer the plant and related activities in State Y, together with that portion of the sales contract with Corporation O applicable to the sales of that plant to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business before and after the transfer to the new corporation.

Example (*14*). Corporation P manufactures and sells steel containers for oil and oil products at a plant in State X and at a plant in State Y. Corporation P makes all of its sales through its wholly-owned subsidiary pursuant to a sales contract, by virtue of which the subsidiary acts either as principal or sales agent for Corporation P. Corporation P proposes to transfer the plant and related activities in State Y, together with that portion of the sales contract applicable to the sales of that plant to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business before and after the transfer to the new corporation.

Example (*15*). Corporation Q manufactures electrical products at a plant in State X and at a plant in State Y. The sales of the electrical products produced by each plant are made by the corporation's sales office located at the plant in State X. Corporation Q proposes to transfer the plant and related activities in State Y, together with that portion of the facilities and personnel of the sales office allocable to the sales of the plant in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each state constitute a trade or business before and after the transfer to the new corporation.

Example (*16*). Corporation R manufactures and sells automobiles and operates an executive dining room primarily for the convenience of its executives. The dining room is managed and operated as a separate unit and the executives are charged for their meals. Corporation R derives a profit from the operation of the dining room. The activities connected with the executive dining room do not constitute a trade or business.

(e) *Businesses operated by one corporation.* For further examples of businesses operated by one corporation, see paragraph (d) of § 1.337–3.

§ 1.355–2 Limitations.

(a) *Property distributed.* The property distributed must consist solely of stock or stock and securities of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) *Distribution of earnings and profits.* (1) The transaction must not have been used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or of both. If, pursuant to an arrangement negotiated or agreed upon prior to the distribution of stock or securities of the controlled corporation, part or all of the stock or securities of either corporation are sold or exchanged after the distribution, such sale or exchange will be evidence that the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corportion or of the controlled corporation, or both. However, if the rules respecting continuity of interest contained in paragraph (c) of this section are not met, section 355 will not apply. If a sale of such stock or securities is made after the distribution and is not pursuant to an arrangement negotiated or agreed upon prior to the distribution, the mere fact of such sale is not determinative that the transaction was used principally as a device for the distribution of earnings and profits, but such fact will be evidence that the transaction was used principally as such a device.

(2) A sale is pursuant to an arrangement agreed upon prior to the distribution when enforcible rights to buy or to sell exist before such distribution. In any case in which a sale or exchange was discussed by the buyer and the seller before the distribution, but enforcible rights to buy or to sell did not exist before such distribution, the question whether an arrangement was negotiated within the meaning of section 355 (a) (1) (B) shall be determined from all the facts and circumstances.

(3) In determining whether a transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or both, consideration will be given to all of the facts and circumstances of the transaction. In particular, consideration will be given to the nature, kind and amount of the assets of both corporations (and corporations controlled by them) immediately after the transaction. The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of section 355 (b) will be considered evidence that the transaction was not used principally as such a device.

(c) *Business purpose.* The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporation. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms. Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. All the requisites of business and corporate purposes described under § 1.368 must be met to exempt a transaction from the recognition of gain or loss under this section.

(d) *Stock and securities distributed.* The distributing corporation must distribute:

(1) All of the stock and securities of the controlled corporation which it owns, or

(2) At least an amount of the stock which constitutes control as defined in section 368 (c). In such case all, or any part, of the securities of the controlled corporation may be distributed.

Where a part of either the stock or securities is retained under subparagraph (2) of this paragraph, it must be established to the satisfaction of the Commissioner that such retention was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the business reasons (as distinguished from the desire to make a distribution of the earnings and profits) which support a distribution of stock and securities of a controlled corporation under paragraph (c) of this section will require the distribution of all of the stock and securities. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of "other property" under section 356, this fact does not tend to establish that the retention of any of such stock and securities is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(e) *Principal amount of securities.* (1) Section 355 (a) (1) is not applicable if the principal amount of securities received exceeds the principal amount of securities surrendered or if securities are received and no securities are surrendered. In such cases, see section 356.

(2) If only stock is received in a transaction to which section 355 is applicable, the principal amount of securities surrendered, if any, and the par or stated value of stock is not relevant to the application of such section. For example: All of the stock of Corporation A is owned by X, an individual, and securities in the principal amount of $100,000 which were issued by Corporation A are owned by Y, an individual. Corporation A distributes all of the stock of a controlled corporation to Y in exchange for his securities. The par or stated value of the stock of the controlled corporation is $150,000. No gain or loss is recognized to Y upon the receipt of the stock of the controlled corporation.

(f) *Period of ownership.* (1) For the purposes of determining whether gain or loss will be recognized upon a distribution, stock of a controlled corporation acquired (in a transaction in which gain or loss is recognized, in whole or in part) within five years of the date of the distribution of such stock is treated as "other property." Section 355 does not apply to a transaction which includes a distribution of such stock. See section 356. The stock so acquired is "stock", however, for the purpose of the requirements respecting the distribution of stock of such controlled corporation provided in section 355 (a) (1) (D).

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Corporation A has held 85 of the 100 outstanding shares of the stock of Corporation B for more than five years on the date of distribution. Six months before such date, it purchased 10 shares of such stock. If all of the stock of the controlled corporation owned by Corporation A is distributed, section 355 is not applicable to such distribution since the 10 shares would represent "other property." See, however, section 356. If, however, for proper business reasons it is decided to retain some of the stock of Corporation B, then the determination of the amount of such stock which must be distributed under section 355 (a) (1) (D) in order to constitute a distribution to which section 355 is applicable must be made by reference to all of the stock of the controlled corporation including the 10 shares acquired six months before such date and the 5 shares owned by others. Similarly, if, by the use of any agency, the distributing corporation acquires stock of the controlled corporation within five years of the date of distribution, for example, where another subsidiary purchases such stock, such stock will be treated as "other property." If Corporation A had held only 75 of the 100 outstanding shares of stock of Corporation B for more than five years on the date of distribution and had purchased the remaining 25 shares six months before such date, neither section 355 nor section 356 would be applicable.

(g) *Active businesses.* The rules of section 355 (b) and § 1.355–4, relating to active businesses, must be satisfied.

§ 1.355–3 Non pro rata distributions, etc.

(a) The rule of section 355(a)(1) prescribing that gain or loss will not be recognized applies whether or not the distribution is pro rata with respect to the interests of all the shareholders in the distributing corporation provided all other requirements of section 355 are satisfied. For example, if two individuals, A and B, own all of the stock of Corporation X which operates two active businesses, one business may be transferred to a new corporation in exchange for all of its stock and such stock distributed to either A or B in exchange for all of his stock of Corporation X. Similarly, if, in the above example, only a part of the stock of the new corporation is transferred to one of the shareholders in exchange for all of his stock of Corporation X and the balance of such stock is distributed to the other shareholder (whether or not such other shareholder surrenders stock in Corporation X), no gain or loss will be recognized. The same rule will be applicable if the stock of an existing controlled corporation is distributed to the shareholders even though such distribution is not pursuant to a plan of reorganization. Section 355 does not apply, however, if the substance of the transaction is merely an exchange between shareholders or security holders of stock or securities in one corporation for stock or securities in another corporation. For example, if two individuals, C and D, each own directly fifty percent of the stock of Corporation M and fifty percent of the stock of Corporation N, section 355 would not apply to a transaction in which C and D transfer all of their stock in Corporation M and Corporation N to a new corporation, P, for all of the stock of Corporation P, and Corporation P then distributes the stock of Corporation M to C and the stock of Corporation N to D.

(b) The stock of the controlled corporation which is distributed may consist of either common or preferred stock. See, however, section 306 with respect to the receipt of preferred stock in a transaction to which section 355 is applicable.

(c) The rule of section 355 (a) (1) prescribing that gain or loss will not be recognized applies whether or not the shareholder surrenders stock in the distributing corporation and whether or

not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a) (1) (D)).

§ 1.355–4 Active conduct of a trade or business.

(a) A distribution of stock or securities of a controlled corporation is subject to section 355(a) only, if:

(1) The distributing corporation and the controlled corporation are each engaged in the active conduct of a trade or business immediately after the distribution of stock or securities of the controlled corporation; or

(2) Immediately before the distribution the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged in the active conduct of a trade or business immediately after the distribution. In connection with the requirement of "no assets" a de minimis rule is applicable.

(3) These rules are illustrated by the following examples:

Example (1). Corporation A, prior to the distribution, operates an active business and owns all of the stock of Corporation B which also is engaged in the active conduct of a business. Corporation A distributes all of the stock of Corporation B to its shareholders, and both continue the operations of their separate businesses. The active business requirement of section 355 (b) (1) (A) is satisfied.

Example (2). The facts are the same as in example 1, except that Corporation A transfers all of its assets except the stock of Corporation B to a new corporation in exchange for all of its stock and transfers the stock of both controlled corporations to its shareholders. The active business requirement of section 355 (b) (1) (B) is satisfied.

(b) (1) Section 355 (b) (2) provides rules for determining whether any corporation is treated as engaged in the active conduct of a trade or business for purposes of ascertaining whether the distributing corporation and the controlled corporation meet the requirements of section 355 (b) (1). Under section 355 (b) (2) (A), a corporation is treated as engaged in the active conduct of a trade or business if it is itself engaged in such a trade or business or if substantially all of its assets consist of the stock and securities of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business. Regardless of whether the determination is based upon a corporation's own conduct of a trade or business or on the basis of its ownership of the stock of a corporation or corporations which conduct a trade or business, such trade or business must have been actively conducted for the five-year period ending on the date of distribution of the stock and securities of the controlled corporation the stock of which was distributed as provided in section 355 (b) (2) (B). Furthermore, such trade or business must not have been acquired by either corporation during such five-year period unless it was acquired in a transaction in which gain or loss was not recognized (section 355 (b) (2) (C)). In addition, under section 355 (b) (2) (D), such business must not have been indirectly acquired during such five-year period by means of the acquisition of control of another corporation in a transaction in which gain or loss was recognized. Thus, section 355 (b) (2) (D) requires that during the five-year period during which the trade or business must be actively conducted, such business cannot have been acquired, directly or indirectly, through another corporation by such other corporation or any of its predecessors in interest in a transaction in which gain or loss was recognized in whole or in part.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. In 1956, Corporation B, having cash and other liquid assets and engaged in only one active business purchases all of the stock of Corporation A, also engaged in a single active business. Later in the same year, Corporation B in a "downstairs" statutory merger merges into Corporation A. In 1958, Corporation A places the assets of the active business formerly operated by Corporation B in a new subsidiary X. A distribution of the stock of Corporation X to the stockholders of Corporation A is not within the terms of section 355, since one of the active businesses had, in effect, been purchased less than five years prior to the distribution.

(3) For the purpose of determining whether such trade or business has been actively conducted throughout the five-year period described in section 355 (b) (2), the fact that during such five-year period such trade or business underwent change (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded provided the changes are not of such a character as to constitute the acquisition of a new or different business.

§ 1.355–5 Records to be kept and information to be filed.

(a) Every corporation that makes a distribution of stock or securities of a controlled corporation, as described in section 355, shall attach to its return for the year of the distribution a detailed statement setting forth such data as may be appropriate in order to show compliance with the provisions of such section.

(b) Every taxpayer who receives a distribution of stock or securities of a corporation that was controlled by a corporation in which he holds stock or securities shall attach to his return for the year in which such distribution is received a detailed statement setting forth such data as may be appropriate in order to show the applicability of section 355. Such statement shall include, but shall not be limited to, a description of the stock and securities surrendered (if any) and received, and the names and addresses of all of the corporations involved in the transaction.

§ 1.356 Statutory provisions; receipt of additional consideration.

SEC. 356. *Receipt of additional consideration*—(a) *Gain on exchanges*—(1) *Recognition of gain.* If—

(A) Section 354 or 355 would apply to an exchange but for the fact that

(B) The property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend.* If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) *Additional consideration received in certain distributions.* If—

(1) Section 355 would apply to a distribution but for the fact that

(2) The property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) *Loss.* If—

(1) Section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that

(2) The property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

(d) *Securities as other property.* For purposes of this section—

(1) *In general.* Except as provided in paragraph (2), the term "other property" includes securities.

(2) *Exceptions*—(A) *Securities with respect to which nonrecognition of gain would be permitted.* The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) *Greater principal amount in section 354 exchange.* If—

(i) In an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) The principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) *Greater principal amount in section 355 transaction.* If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

(e) *Exchanges for section 306 stock.* Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be

treated as a distribution of property to which section 301 applies.

(f) *Transactions involving gift or compensation.* For special rules for a transaction described in section 354, 355, or this section, but which—

(1) Results in a gift, see section 2501 and following, or

(2) Has the effect of the payment of compensation, see section 61 (a) (1).

§ 1.356–1 Receipt of additional consideration in connection with an exchange.

(a) If in any exchange to which the provisions of section 354 or section 355 would apply except for the fact that there is received by the shareholders or the security holders other property (in addition to property permitted to be received without recognition of gain by such sections) or money, then—

(1) The gain, if any, to the taxpayer shall be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but,

(2) The loss, if any, to the taxpayer from the exchange or distribution shall not be recognized to any extent.

(b) If the distribution of such other property or money by or on behalf of a corporation has the effect of the distribution of a dividend, then there shall be chargeable to each distributee (either an individual or a corporation)—

(1) As a dividend, such an amount of the gain recognized as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and

(2) As a gain from the exchange of property, the remainder of the gain so recognized.

(c) This section may be illustrated by the following examples:

Example (1). In an exchange to which the provisions of section 356 apply and to which section 354 would apply but for the receipt of property not permitted to be received without the recognition of gain or loss, A (either an individual or a corporation), received the following in exchange for a share of stock having an adjusted basis to him of $85:

One share of stock worth	$100
Cash	25
Other property (basis $25) fair market value	50
Total fair market value of consideration received	175
Adjusted basis of stock surrendered in exchange	$85
Total gain	90
Gain to be recognized, limited to cash and other property received	75
A's pro rata share of earnings and profits accumulated after February 28, 1913 (taxable dividend)	30
Remainder to be treated as a gain from the exchange of property	45

Example (2). If, in example (1), A's stock had an adjusted basis to him of $200, he would have realized a loss of $25 on the exchange, which loss would not be recognized.

(d) Section 301 (b) (1) (B) and section 301 (d) (2) do not apply to a distribution of "other property" to a corporate shareholder if such distribution is within the provisions of section 356.

(e) See paragraph (l) of § 1.301–1 for certain transactions which are not within the scope of section 356.

§ 1.356–2 Receipt of additional consideration not in connection with an exchange.

(a) If, in a transaction to which section 355 would apply except for the fact that a shareholder (individual or corporate) receives property permitted by section 355 to be received without the recognition of gain, together with other property or money, without the surrender of any stock or securities of the distributing corporation, then the sum of the money and the fair market value of the other property as of the date of the distribution shall be treated as a distribution of property to which the rules of section 301 (other than section 301 (b) and section 301 (d)) apply. See section 358 for determination of basis of such other property.

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example (1). Individuals A and B each own 50 of the 100 outstanding shares of common stock of Corporation X. Corporation X owns all of the stock of Corporation Y, 100 shares. Corporation X distributes to each shareholder 50 shares of the stock of Corporation Y plus $100 cash without requiring the surrender of any shares of its own stock. The $100 cash received by each is treated as a distribution of property to which the rules of section 301 apply.

Example (2). If, in the above example, Corporation X distributes 50 shares of stock of Corporation Y to A and 30 shares of such stock plus $100 cash to B without requiring the surrender of any of its own stock, the amount of cash received by B is treated as a distribution of property to which the rules of section 301 apply.

§ 1.356–3 Rules for treatment of securities as "other property".

(a) As a general rule, for purposes of section 356, the term "other property" includes securities. However, it does not include securities permitted under section 354 or section 355 to be received tax free. Thus, when securities are surrendered in a transaction to which section 354 or section 355 is applicable, the characterization of the securities received as "other property" does not include securities received where the principal amount of such securities does not exceed the principal amount of securities surrendered in the transaction. If a greater principal amount of securities is received in an exchange described in section 354 (other than subsection (c) thereof) or section 355 over the principal amount of securities surrendered, the term "other property" includes the fair market value of such excess principal amount as of the date of the exchange. If no securities are surrendered in exchange, the term "other property" includes the fair market value, as of the date of receipt, of the entire principal amount of the securities received.

(b) The following examples illustrate the application of the above regulations:

Example (1). A, an individual, exchanged 100 shares of stock for 100 shares of stock and a security in the principal amount of $1,000 with a fair market value of $990. The amount of $990 is treated as "other property."

Example (2). B, an individual, exchanged 100 shares of stock and a security in the principal amount of $1,000 for 300 shares of stock and a security in the principal amount of $1,500. The security had a fair market value on the date of receipt of $1,575. The fair market value of the excess principal amount, or $525, is treated as "other property."

Example (3). C, an individual, exchanged a security in the principal amount of $1,000 for 100 shares of stock and a security in the principal amount of $900. No part of the security received is treated as "other property."

Example (4). D, an individual, exchanged a security in the principal amount of $1,000 for 100 shares of stock and a security in the principal amount of $1,200 with a fair market value of $1,100. The fair market value of the excess principal amount, or $183.33, is treated as "other property."

Example (5). E, an individual, exchanged a security in the principal amount of $1,000 for another security in the principal amount of $1,200 with a fair market value of $1,080. The fair market value of the excess principal amount, or $180, is treated as "other property."

Example (6). F, an individual, exchanged a security in the principal amount of $1,000 for two different securities each in the principal amount of $750. One of the securities had a fair market value of $750, the other had a fair market value of $600. One-third of the fair market value of each security ($250 and $200) is treated as "other property."

§ 1.356–4 Exchanges for section 306 stock.

If, in a transaction to which section 356 is applicable, other property or money is received in exchange for section 306 stock, an amount equal to the fair market value of the property plus the money, if any, shall be treated as a distribution of property to which section 301 is applicable. The determination of whether section 306 stock is surrendered for other property (including money) is a question of fact to be decided under all of the circumstances of each case. Ordinarily, the other property (including money) received will first be treated as received in exchange for any section 306 stock owned by a shareholder prior to such transaction. For example, if a shareholder who owns a share of common stock (having a basis to him of $100) and a share of preferred stock which is section 306 stock (having a basis to him of $100) surrenders both shares in a transaction to which section 356 is applicable for one share of common stock having a fair market value of $80 and one $100 bond having a fair market value of $100, the bond will be deemed received in exchange for the section 306 stock and it will be treated as a distribution to which section 301 is applicable to the extent of its entire fair market value ($100).

§ 1.356–5 Transactions involving gift or compensation.

With respect to transactions described in sections 354, 355, or 356, but which—

(a) Result in a gift, see section 2501 and following, and the regulations pertaining thereto, or

(b) Have the effect of the payment of compensation, see section 61 (a) (1), and the regulations pertaining thereto.

§ 1.357 Statutory provisions; assumption of liability.

SEC. 357. *Assumption of liability*—(a) *General rule.* Except as provided in subsections (b) and (c), if—

(1) The taxpayer receives property which would be permitted to be received under section 351, 361, or 371 without the recognition of gain if it were the sole consideration, and

(2) As part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, or 371, as the case may be.

(b) *Tax avoidance purpose*—(1) *In general.* If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) Was a purpose to avoid Federal income tax on the exchange, or

(B) If not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, or 371 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) *Burden of proof.* In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) *Liabilities in excess of basis*—(1) *In general.* In the case of an exchange—

(A) To which section 351 applies, or

(B) To which section 361 applies by reason of a plan of reorganization within the meaning of section 368 (a) (1) (D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) *Exceptions.* Paragraph (1) shall not apply to any exchange to which—

(A) Subsection (b) (1) of this section applies, or

(B) Section 371 applies.

§ 1.357–1 Assumption of liability.

(a) *General rule.* Section 357 (a) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 1001 upon an exchange. Section 357 (a) provides, subject to the exceptions and limitations specified in section 357 (b) and (c), that:

(1) Liabilities assumed are not to be treated as "other property or money" for the purpose of determining the amount of realized gain which is to be recognized under section 351, 361, or 371, if the transactions would, but for the receipt of "other property or money" have been exchanges of the type described in any one of such sections; and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 351, 361, or 371, consists of an assumption of liabilities, the transaction, if otherwise qualified, will be deemed to be within the provisions of section 351, 361, or 371.

(b) *Application of general rule.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, $3,000 cash, and the assumption by the corporation of indebtedness of A amounting to $4,000. A's gain is $5,000, computed as follows:

Stock received, fair market value	$8,000
Cash received	3,000
Liability assumed by transferee	4,000
Total consideration received	15,000
Less: Adjusted basis of property transferred	10,000
Gain realized	5,000

Assuming that the exchange falls within section 351 as a transaction in which the gain to be recognized is limited to "other property or money" received, the gain recognized to A will be limited to the $3,000 cash received, since, under the general rule of section 357 (a), the assumption of the $4,000 liability does not constitute "other property."

(c) *Tax avoidance purpose.* The benefits of section 357 (a) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the total amount of liabilities assumed or acquired pursuant to such exchange (and not merely a particular liability with respect to which the tax avoidance purpose existed) shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed or acquired, be treated as money received by the taxpayer upon the exchange. Thus, if in the example set forth in paragraph (b) of this section, the principal purpose of the assumption of the $4,000 liability was to avoid tax on the exchange, or was not a bona fide business purpose, then the amount of gain recognized would be $5,000. In any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as "other property or money" under section 357, which is the case if the Commissioner determines that the taxpayer's purpose with respect thereto was a purpose to avoid Federal income tax on the exchange or was not a bona fide business purpose, and the taxpayer contests such determination by litigation, the taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

§ 1.357–2 Liability in excess of basis.

(a) Section 357(c) provides in general that in an exchange to which section 351 (relating to a transfer to a corporation controlled by the transferor) is applicable, or to which section 361 (relating to the nonrecognition of gain or loss to corporations) is applicable by reason of a section 368 (a) (1) (D) reorganization, if the sum of the amount of liabilities assumed plus the amount of liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset as the case may be. Thus, if an individual transfers, under section 351, properties having a total basis in his hands of $20,000, one of which has a basis of $10,000 but is subject to a mortgage of $30,000, to a corporation controlled by him, such individual will be subject to tax with respect to $10,000, the excess of the amount of the liability over the total adjusted basis of all the properties in his hands. The same result will follow whether or not the liability is assumed by the transferee. The determination of whether a gain resulting from the transfer of capital assets is long or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred. An exception to the general rule of section 357 (c) is made (1) for any exchange as to which under section 357 (b) (relating to assumption of liabilities for tax avoidance purposes) the entire amount of the liabilities is treated as money received, and (2) for an exchange to which section 371 (relating to reorganizations in certain receivership and bankruptcy proceedings) is applicable.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). If all such assets transferred are capital assets and if half the assets (ascertained by reference to their fair market value at the time of the transfer) have been held for less than 6 months and the remaining half for more than 6 months, half the excess of the amount of the liability over the total of the adjusted basis of the property transferred pursuant to the exchange shall be treated as short-term capital gain, and the remaining half shall be treated as long-term capital gain.

Example (2). If half of the assets (ascertained by reference to their fair market value at the time of the transfer) transferred are capital assets and half are assets other than capital assets, then half of the excess of the amount of the liability over the total of the adjusted basis of the property transferred pursuant to the exchange shall be treated as capital gain, and the remaining half shall be treated as gain from the sale or exchange of assets other than capital assets.

§ 1.358 Statutory provisions; basis to distributees.

SEC. 358. *Basis to distributees*—(a) *General rule.* In the case of an exchange to which section 351, 354, 355, 356, 361 or 371 (b) applies—

(1) *Nonrecognition property.* The basis of the property permitted to be received under such section without the recognition

of gain or loss shall be the same as that of the property exchanged—

(A) Decreased by—

(i) The fair market value of any other property (except money) received by the taxpayer, and

(ii) The amount of any money received by the taxpayer, and

(B) Increased by—

(i) The amount which was treated as a dividend, and

(ii) The amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) *Other property.* The basis of any other property (except money) received by the taxpayer shall be its fair market value.

(b) *Allocation of basis*—(1) *In general.* Under regulations prescribed by the Secretary or his delegate, the basis determined under subsection (a) (1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

(2) *Special rule for section 355.* In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

(c) *Section 355 transactions which are not exchanges.* For purposes of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

(d) *Assumption of liability.* Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(e) *Exception.* This section shall not apply to property acquired by a corporation by the issuance of its stock or securities as consideration in whole or in part for the transfer of the property to it.

§ 1.358–1 Basis to distributees.

(a) In the case of an exchange or distribution to which section 354, 355, or 371(b) applies in which, under the law applicable to the year in which the exchange is made, only nonrecognition property is received, the sum of the basis of all of the stock and securities in the corporation whose stock and securities are exchanged or with respect to which the distribution is made, held immediately after the transaction, plus the basis of all stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation held immediately before the transaction allocated in the manner described in § 1.358–2. In the case of an exchange to which section 351 or 361 applies in which, under the law applicable to the year in which the exchange was made, only nonrecognition property is received, the basis of all the stock and securities received in the exchange shall be the same as the basis of all property exchanged therefor. If in an exchange or distribution to which section 351, 356, 361, or 371(b) applies both nonrecognition property and "other property" are received, the basis of all the property except "other property" held after the transaction shall be determined as described in the preceding two sentences decreased by the sum of the money and the fair market value of the "other property" (as of the date of the transaction) and increased by the sum of the amount treated as a dividend (if any) and the amount of the gain recognized on the exchange, but the term "gain" as here used does not include any portion of the recognized gain that was treated as a dividend. The basis of the "other property" is its fair market value as of the date of the transaction.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. A purchased a share of stock in Corporation X in 1935 for $150. Since that date he has received distributions out of other than earnings and profits (as defined in section 316) totalling $60, so that his adjusted basis for the stock is $90. In a transaction qualifying under section 356, A exchanged this share for one share in Corporation Y, worth $100, cash in the amount of $10, and other property with a fair market value of $30. The exchange had the effect of the distribution of a dividend. A's ratable share of the earnings and profits of Corporation X accumulated after February 28, 1913, was $5. A realized a gain of $50 on the exchange, but the amount recognized is limited to $40, the sum of the cash received and the fair market value of the other property. Of the gain recognized, $5 is taxable as a dividend, and $35 as a gain from the exchange of property. The basis to A of the one share of stock of Corporation Y is $90, that is, the adjusted basis of the one share of stock of Corporation X ($90), decreased by the sum of the cash received ($10) and the fair market value of the other property received ($30) and increased by the sum of the amount treated as a dividend ($5) and the amount treated as a gain from the exchange of property ($35). The basis of the other property received is $30.

§ 1.358–2 Allocation of basis among nonrecognition property.

(a) (1) As used in this paragraph the term "stock" means stock which is not "other property" under section 356 or 371(b), stock with respect to which a distribution is made, and, in the case of a surrender of part of the stock of a particular class, the retained part of such stock. The term "securities" means securities (including, where appropriate, fractional parts of securities) which are not "other property" under section 356 or 371(b) and in the case of a surrender of part of the securities of a particular class, the retained part of such securities. Stock, or securities, as the case may be, which differ either because they are in different corporations or because the rights attributable to them differ (although they are in the same corporation) are considered different classes of stock or securities, as the case may be, for purposes of this section.

(2) If as the result of an exchange or distribution under the terms of section 354, 355, 356 or 371 (b) a shareholder who owned stock of only one class before the transaction owns stock of two or more classes after the transaction, then the basis of all the stock held before the transaction (as adjusted under § 1.358–1) shall be allocated among the stock of all classes (whether or not such stock was received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class.

(3) If as the result of an exchange under the terms of section 354, 355, 356 or 371 (b) a security holder who owned only securities, all of one class, before the transaction, owns securities or stock of more than one class, or owns both stock and securities, then the basis of all the securities held before the transaction (as adjusted under § 1.358–1) shall be allocated among all the stock and securities (whether or not received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class and the securities of each class.

(4) In every case in which, before the transactions, a person owned stock of more than one class or securities of more than one class or owned both stock and securities, a determination must be made, upon the basis of all the facts, of the stock or securities received with respect to stock and securities of each class held (whether or not surrendered). The allocation described in subparagraph (2) of this paragraph shall be separately made as to the stock of each class with respect to which there is an exchange or distribution and the allocation described in subparagraph (3) of this paragraph shall be separately made with respect to the securities of each class, part or all of which are surrendered in the exchange.

(5) Notwithstanding the provisions of subparagraphs (2), (3), and (4) of this paragraph, in any case in which a plan of recapitalization under section 368 (a) (1) (E) provides that each holder of stock or securities of a particular class shall have an option to surrender some or none of such stock or securities in exchange for stock or securities, and a shareholder or security holder exchanges an identifiable part of his stock or securities, the basis of the part of the stock or securities retained shall remain unchanged and shall not be taken into account in determining the basis of the stock or securities received.

(b) (1) As used in this paragraph the term "stock" refers only to stock which is not "other property" under section 351 or 361 and the term "securities" refers only to securities which are not "other property" under section 351 or 361.

(2) If in an exchange to which section 351 or 361 applies property is transferred to a corporation and the transferor receives stock or securities of more than one class or receives both stock and securities, then the basis of the property transferred (as adjusted under § 1.358–1) shall be allocated among all of the stock and securities received in proportion to the fair market values of the stock of each class and the securities of each class.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). A, an individual, owns stock in Corporation X with an adjusted basis of $1,000. In a transaction qualifying under section 356 (so far as such section re-

lates to section 354), he exchanged this stock for 20 shares of stock of Corporation Y worth $1,200 and securities of Corporation Y worth $400. A realizes a gain of $600 of which $400 is recognized. The adjusted basis in A's hands of each share of the stock of Corporation Y is $50 determined by allocating the basis of the stock of Corporation X ratably to the stock of Corporation Y received in the exchange. The securities of Corporation Y have a basis in the hands of A of $400.

Example (2). B, an individual, owns a security in the principal amount of $10,000 with a basis of $5,000. In a transaction to which section 354 is applicable, he exchanges this security for four securities in the principal amount of $750 each, worth $800 each, four securities in the principal amount of $750 each, worth $600 each, class A common stock worth $1,000, and class B common stock worth $400. B realizes a gain of $2,000 none of which is recognized. The basis of his original security, $5,000, will be allocated 32/70ths to the four securities worth $800, 24/70ths to the four securities worth $600, 10/70ths to the class A common stock, and 4/70ths to the class B common stock.

Example (3). C, an individual, owns stock of Corporation Y with a basis of $5,000 and owns a security issued by Corporation Y in the principal amount of $5,000 with a basis of $5,000. In a transaction to which section 354 is applicable, he exchanges the stock of Corporation Y for stock of Corporation Z with a value of $6,000, and he exchanges the security of Corporation Y for stock of Corporation Z worth $1,500 and a security of Corporation Z in the principal amount of $4,500 worth $4,500. No gain is recognized to C on either exchange. The basis of the stock of Corporation Z received for the stock of Corporation Y is $5,000. The bases of the stock and security of Corporation Z received in exchange for the security of Corporation Y are $1,250 and $3,750, respectively.

Example (4). D, an individual, owns stock in Corporation M with a basis of $15,000, worth $40,000, and owns a security issued by Corporation M in the principal amount of $5,000 with a basis of $4,000. In a transaction qualifying under section 356 (so far as such section relates to section 355), he exchanges the security of Corporation M for a security of Corporation O (a controlled corporation) in the principal amount of $5,000, worth $5,000, and exchanges one-half of his stock of Corporation M for stock of Corporation O worth $15,000 and a security of Corporation O in the principal amount of $5,000, worth $5,000. All of the stock and securities of Corporation O are distributed pursuant to the transaction. D realizes a gain of $12,500 on the exchange of the stock of Corporation M for the stock and security of Corporation O of which $5,000 is recognized. D also realizes a gain of $1,000 on the exchange of a security of Corporation M for a security of Corporation O, none of which is recognized. The basis of his stock of Corporation M held before the transaction is allocated 20/35ths to the stock of Corporation M held after the transaction and 15/35ths to the stock of Corporation O. The basis of the security of Corporation O received in exchange for his security of Corporation M is $4,000, the basis of the security of Corporation M exchanged. The basis of the security of Corporation O received with respect to D's stock of Corporation M is $5,000, its fair market value.

§ 1.358–3 Treatment of assumption of liabilities.

(a) For purposes of section 358, where a party to the exchange assumes a liability of a distributee or acquires from him property subject to a liability, the amount of such liability is to be treated as money received by the distributee upon the exchange, whether or not the assumption of liabilities resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). A, an individual, owns property with an adjusted basis of $100,000 on which there is a purchase money mortgage of $25,000. On December 1, 1954, A organizes Corporation X to which he transfers the property in exchange for all the stock of Corporation X and the assumption by Corporation X of the mortgage. The capital stock of the Corporation X has a fair market value of $150,000. Under sections 351 and 357, no gain or loss is recognized to A. The basis in A's hands of the stock of Corporation X is $75,000, computed as follows:

Adjusted basis of property transferred	$100,000
Less: Amount of money received (amount of liabilities assumed)	25,000
Basis of Corporation X stock to A	75,000

Example (2). A, an individual, owns property with an adjusted basis of $25,000 on which there is a mortgage of $50,000. On December 1, 1954, A organizes Corporation X to which he transfers the propefty in exchange for all the stock of Corporation X and the assumption by Corporation X of the mortgage. The stock of Corporation X has a fair market value of $50,000. Under sections 351 and 357, gain is recognized to A in the amount of $25,000. The basis in A's hands of the stock of Corporation X is zero, computed as follows:

Adjusted basis of property transferred	$25,000
Less: Amount of money received (amount of liabilities)	−50,000
Plus: Amount of gain recognized to taxpayer	25,000
Basis of Corporation X stock to A	0

§ 1.358–4 Exception.

Section 358 does not apply in determining the basis of property acquired by a corporation by the issuance of its stock or securities (or by the issuance of stock or securities of another corporation which is in control of such corporation) as the consideration in whole or in part for the transfer of the property to it. See section 362 and the regulations pertaining to that section for rules relating to basis to corporations of property acquired in such cases.

EFFECTS ON CORPORATION

§ 1.361 Statutory provisions; nonrecognition of gain or loss to corporations.

SEC. 361. *Nonrecognition of gain or loss to corporations*—(a) *General rule.* No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) *Exchanges not solely in kind*—(1) *Gain.* If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then—

(A) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(2) *Loss.* If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

§ 1.361–1 Nonrecognition of gain or loss to corporations.

Section 361 provides the general rule that no gain or loss shall be recognized if a corporation, a party to a reorganization, exchanges property in pursuance of the plan of reorganization solely for stock or securities in another corporation, a party to the reorganization. This provision includes only stock and securities received in connection with a reorganization defined in section 368(a). It also includes nonvoting stock and securities in a corporation, a party to a reorganization, received in a transaction to which section 368(a)(1)(C) is applicable only by reason of section 368(a)(2)(B).

§ 1.362 Statutory provisions; basis to corporations.

SEC. 362. *Basis to corporations*—(a) *Property acquired by issuance of stock or as paid-in surplus.* If property was acquired on or after June 22, 1954, by a corporation—

(1) In connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) As paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) *Transfers to corporations.* If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

(c) *Special rule for certain contributions to capital*—(1) *Property other than money.* Notwithstanding subsection (a) (2), if property other than money—

(A) Is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) Is not contributed by a shareholder as such, then the basis of such property shall be zero.

(2) *Money.* Notwithstanding subsection (a) (2), if money—

(A) Is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) Is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.

§ 1.362–1 Basis to corporations.

Section 362 provides, as a general rule, that if property was acquired on or after June 22, 1954, by a corporation in connection with (a) a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, (b) as paid-in surplus or as a contribution to capital, or (c) in connection with a reorganization to which part III, subchapter C, chapter 1 of the Code, applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. Section 362 does not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (See also § 1.362–2.)

§ 1.362–2 Certain contributions to capital.

The following regulations shall be used in the application of section 362(c):

(a) Property deemed to be acquired with contributed money shall be that property, if any, the acquisition of which was the purpose motivating the contribution;

(b) In the case of an excess of the amount of money contributed over the cost of the property deemed to be acquired with such money (as defined in paragraph (a) of this section) such excess shall be applied to the reduction of the basis (but not below zero) of other properties held by the corporation, on the last day of the 12-month period beginning on the day the contribution is received, in the following order—

(1) All property of a character subject to an allowance for depreciation (not including any properties as to which a deduction for amortization is allowable),

(2) Property with respect to which a deduction for amortization is allowable,

(3) Property with respect to which a deduction for depletion is allowable under section 611 but not under section 613, and

(4) All other remaining properties.

The reduction of the basis of each of the properties within each of the above categories shall be made in proportion to the relative bases of such properties.

(c) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its return for the taxable year for which the transfer of the property has occurred.

§ 1.363 Statutory provisions; effect on earnings and profits.

SEC. 363. *Effect on earnings and profits.* For rules relating to the effect on earnings and profits of transactions to which this part applies, see sections 312 and 381.

SPECIAL RULE; DEFINITIONS

§ 1.367 Statutory provisions; foreign corporations.

SEC. 367. *Foreign corporations.* In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

§ 1.367–1 Foreign corporations.

Whether any one of the exchanges or distributions described in section 332, 351, 354, 355, 356, or 361, involving a foreign corporation, is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax, is a question of fact. In any such case if a taxpayer desires to establish that an exchange or distribution is not in pursuance of such a plan, a statement under oath of the facts and circumstances relating to the plan under which the exchange or distribution is to be made, together with a copy of the plan, shall be forwarded to the Commissioner of Internal Revenue, Washington 25, D. C., for a ruling. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If the Commissioner determines that the exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax, the taxpayer should retain a copy of the Commissioner's letter as authority for treating the foreign corporation as a corporation in determining the extent to which gain is recognized from the exchange or distribution. If the transaction is not carried out in accordance with the plan submitted, the Commissioner's approval will not render the transaction tax-free.

§ 1.368 Statutory provisions; definitions relating to corporate reorganizations.

SEC. 368. *Definitions relating to corporate reorganizations*—(a) *Reorganization*—(1) *In general.* For purposes of parts I and II and this part, the term "reorganization" means—

(A) A statutory merger or consolidation;

(B) The acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) A transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) A recapitalization; or

(F) A mere change in identity, form, or place of organization, however effected.

(2) *Special rules relating to paragraph (1)—(A) Reorganizations described in both paragraph (1) (C) and paragraph (1) (D).* If a transaction is described in both paragraph (1) (C) and paragraph (1) (D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1) (D).

(B) *Additional consideration in certain paragraph (1) (C) cases.* If—

(i) One corporation acquires substantially all of the properties of another corporation,

(ii) The acquisition would qualify under paragraph (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) The acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) *Transfers of assets to subsidiaries in certain paragraph (1) (A) and (1) (C) cases.* A transaction otherwise qualifying under paragraph (1) (A) or paragraph (1) (C) shall not be disqualified by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.

(b) *Party to a reorganization.* For purposes of this part, the term "a party to a reorganization" includes—

(1) A corporation resulting from a reorganization, and

(2) Both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1) (C) of subsection (a), if the stock exchanged for the properties is stock of a corporation which is in control of the acquiring corporation, the term "a

party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1) (A) or (1) (C) of subsection (a) by reason of paragraph (2) (C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets are transferred.

(c) *Control.* For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

§ 1.368–1 Purpose and scope of exception of reorganization exchanges.

(a) *Reorganizations.* As used in the regulations under parts I, II, and III (section 301 and following), subchapter C, chapter 1 of the Code, the terms "reorganization" and "party to a reorganization" mean only a reorganization or a party to a reorganization as defined in subsections (a) and (b) of section 368. With respect to insolvency reorganizations, see part IV, subchapter C, chapter 1 of the Code.

(b) *Purpose.* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and (except as provided in section 368 (a) (1) (D)) a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

(c) *Scope.* The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 354 (a) (1) in which stock or securities in a corporation, a party to a reorganization, are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation, a party to the same reorganization; and the exchange that is provided for in section 361 (a) in which a corporation, a party to a reorganization, exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation, a party to the same reorganization. Section 368 (a) (1) limits the definition of the term "reorganization" to six kinds of transactions and excludes all others. From its context, the term "a party to a reorganization" can only mean a party to a transaction specifically defined as a reorganization by section 368 (a). Certain rules respecting boot received in either of the two types of exchanges provided for in section 354 (a) (1) and section 361 (a) are prescribed in sections 356, 357, and 361 (b). A special rule respecting a transfer of property with a liability in excess of its basis is prescribed in section 357 (c). Under section 367 a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope. The provisions of the Code referred to in this paragraph are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368 (a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

§ 1.368–2 Definition of terms.

(a) The application of the term "reorganization" is to be strictly limited to the specific transactions set forth in section 368 (a). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its shareholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange in which gain or loss is not recognized.

(b) The words "statutory merger or consolidation" refer to a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia.

(c) In order to qualify as a "reorganization" under section 368 (a) (1) (B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation, and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, Corporation X, in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of Corporation Y, the transaction is not a reorganization under section 368 (a) (1) (B). The acquisition of stock of another corporation by the acquiring corporation solely for its voting stock is permitted tax-free even though the acquiring corporation already owns some of the stock of the other corporation. Such an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months. For example, Corporation A purchased 30 percent of the common stock of Corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, Corporation A offers to exchange its own voting stock for all the stock of Corporation W tendered within 6 months from the date of the offer. Within the 6 months' period Corporation A acquires an additional 60 percent of the stock of Corporation W solely for its own voting stock, so that it owns 90 percent of the stock of Corporation W. No gain or loss is recognized with respect to the exchanges of stock of Corporation A for stock of Corporation W. For this purpose, it is immaterial whether such exchanges occurred before Corporation A acquired control (80 percent) of Corporation W or after such control was acquired. If Corporation A had acquired 80 percent of the stock of Corporation W for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.

(d) In order to qualify as a reorganization under section 368 (a) (1) (C), the transaction must be one described in subparagraph (1) or (2) of this paragraph:

(1) One corporation must acquire substantially all the properties of another corporation solely in exchange for all or a part of its own voting stock, or solely in exchange for all or a part of the voting stock of a corporation which is in control of the acquiring corporation. For example, Corporation P owns all the stock of Corporation A. All the properties of Corporation W are transferred to Corporation A either solely in exchange for voting stock of Corporation P or solely in exchange for less than 80 percent of the voting stock of Corporation A. Either of such transactions constitutes a

reorganization under section 368 (a) (1) (C). However, if the properties of Corporation W are acquired in exchange for voting stock of both Corporation P and Corporation A, the transaction will not constitute a reorganization under section 368 (a) (1) (C). In determining whether the exchange meets the requirement of "solely for voting stock", the assumption by the acquiring corporation of liabilities of the transferor corporation, or the fact that property acquired from the transferor corporation is subject to a liability, shall be disregarded. Though such an assumption does not prevent an exchange from being solely for voting stock for the purposes of the definition of a reorganization contained in section 368 (a) (1) (C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 368 (a) (1) (C) does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirement that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities.

(2) One corporation:

(i) Must acquire substantially all of the properties of another corporation in such manner that the acquisition would qualify under (1) above, but for the fact that the acquiring corporation exchanges money, or other property in addition to such voting stock, and

(ii) Must acquire solely for voting stock (either of the acquiring corporation or of a corporation which is in control of the acquiring corporation) properties of the other corporation having a fair market value which is at least 80 percent of the fair market value of all the properties of the other corporation.

(3) For the purposes of subparagraph (2) (ii) only, a liability assumed or to which the properties are subject is considered money paid for the properties. For example, Corporation A has properties with a fair market value of $100,000 and liabilities of $10,000. In exchange for these properties, Corporation Y transfers its own voting stock, assumes the $10,000 liabilities, and pays $8,000 in cash. The transaction is a reorganization even though a part of the properties of Corporation A is acquired for cash. On the other hand, if the properties of Corporation A worth $100,000, were subject to $50,000 in liabilities, an acquisition of all the properties, subject to the liabilities, for any consideration other than solely voting stock would not qualify as a reorganization under this section since the liabilities alone are in excess of 20 percent of the fair market value of the properties. If the transaction would qualify under either subparagraph (1) or (2) of this paragraph and also under section 368 (a) (1) (D), such transaction shall not be treated as a reorganization under section 368 (a) (1) (C).

(e) A "recapitalization", and therefore a reorganization, takes place if, for example:

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) A corporaton issues preferred stock, previously authorized but unissued, for outstanding common stock;

(4) An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights;

(5) An exchange is made of an amount of a corporation's outstanding preferred stock with dividends in arrears for a similar amount of a corporation's preferred stock plus an amount of stock (preferred or common) with respect to the amount of dividends in arrears. However, if such an exchange is made solely for the purpose of effecting the payment of dividends for the current and immediately preceding taxable years upon the preferred stock exchanged, an amount equal to the value of the stock issued in lieu of such dividends shall be treated as a distribution to which section 305 (b) (1) is applicable.

(f) The term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations, in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. A corporation remains a party to the reorganization although it transfers all or part of the assets acquired to a controlled subsidiary. A corporation controlling an acquiring corporation is a party to the reorganization when the stock of such controlling corporation is used in the acquisition of properties. Both corporations are parties to the reorganization if, under statutory authority, Corporation A is merged into Corporation B. All three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporation C and Corporation D are consolidated into Corporation E. Both corporations are parties to the reorganization if Corporation F transfers substantially all its assets to Corporation G in exchange for all or a part of the voting stock of Corporation G. All three corporations are parties to the reorganization if Corporation H transfers substantially all its assets to Corporation K in exchange for all or a part of the voting stock of Corporation L, which is in control of Corporation K. Both corporations are parties to the reorganization if Corporation M transfers all or part of its assets to Corporation N in exchange for all or a part of the stock and securities of Corporation N, but only if (1) immediately after such transfer, Corporation M, or one or more of its shareholders (including persons who were shareholders immediately before such transfer), or any combination thereof, is in control of Corporation N, and (2) in pursuance of the plan, the stock and securities of Corporation N are transferred or distributed by Corporation M in a transaction in which gain or loss is not recognized under section 354 or 355, or is recognized only to the extent provided in section 356. Both Corporation O and Corporation P, but not Corporation S, are parties to the reorganization if Corporation O acquires stock of Corporation P from Corporation S in exchange solely for a part of the voting stock of Corporation O, if (1) the stock of Corporation P does not constitute substantially all of the assets of Corporation S, (2) Corporation S is not in control of Corporation O immediately after the acquisition, and (3) Corporation O is in control of Corporation P immediately after the acquisition.

(g) The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 368 (a). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 368 (a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368 (a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368 (a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368 (a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

(h) As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction "or" denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if "stock and securities" are received in exchange as well as if "stock or securities" are received.

§ 1.368–3 Records to be kept and information to be filed with returns.

(a) The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation. Each corporation, a party to a reorganization, shall file as a part of its return for its taxable year within which the reorganization occurred a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the reorganization, including:

(1) A certified copy of the plan of reorganization, together with a statement under oath or affirmation showing in full the purposes thereof and in detail all transactions incident to, or pursuant to, the plan.

(2) A complete statement of the cost or other basis of all property, including

all stock or securities, transferred incident to the plan.

(3) A statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(4) A statement of the amount and nature of any liabilities assumed upon the exchange, and the amount and nature of any liabilities to which any of the property acquired in the exchange is subject.

(b) Every taxpayer, other than a corporation a party to the reorganization, who receives stock or securities and other property or money upon a tax-free exchange in connection with a corporate reorganization shall incorporate in his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange including:

(1) A statement of the cost or other basis of the stock or securities transferred in the exchange, and

(2) A statement in full of the amount of stock or securities and other property or money received from the exchange, including any liabilities assumed upon the exchange, and any liabilities to which property received is subject. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(c) Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed on the exchange, or any liabilities to which any of the properties received were subject), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.

INSOLVENCY REORGANIZATIONS

§ 1.371 Statutory provisions; reorganization in certain receivership and bankruptcy proceedings.

SEC. 371. *Reorganization in certain receivership and bankruptcy proceedings*—(a) *Exchanges by corporations*—(1) *In general.* No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77 (m) of the Bankruptcy Act (49 Stat. 922; 11 U. S. C. 205)) is transferred in pursuance of an order of the court having jurisdiction of such corporation—

(A) In a receivership, foreclosure, or similar proceeding, or

(B) In a proceeding under chapter X of the Bankruptcy Act (52 Stat. 883–905; 11 U. S. C., chapter 10) or the corresponding provisions of prior law,

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.

(2) *Gain from exchanges not solely in kind.* If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by paragraph (1) to be received without the recognition of gain, but also of other property or money, then—

(A) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(b) *Exchanges by security holders*—(1) *In general.* No gain or loss shall be recognized on an exchange consisting of the relinquishment or extinguishment of stock or securities in a corporation the plan of reorganization of which is approved by the court in a proceeding described in subsection (a), in consideration of the acquisition solely of stock or securities in a corporation organized or made use of to effectuate such plan of reorganization.

(2) *Gain from exchanges not solely in kind.* If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of property permitted by paragraph (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) *Loss from exchanges not solely in kind.* If an exchange would be within the provisions of subsection (a) (1) or (b) (1) if it were not for the fact that the property received in exchange consists not only of property permitted by subsection (a) (1) or (b) (1) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) *Assumption of liabilities.* In the case of a transaction involving an assumption of a liability or the acquisition of property subject to a liability, the rules provided in section 357 shall apply.

§ 1.371–1 Exchanges by corporations.

(a) *Exchange solely for stock or securities.* (1) Section 371 (a) (1) provides for the nonrecognition of gain or loss by a corporation upon certain exchanges made in connection with the reorganization of an insolvent corporation. The section does not apply to a railroad corporation as defined in section 77 (m) of the Bankruptcy Act (11 U.S.C. 205 (m)). In order to qualify as a section 371(a) reorganization, the transaction must satisfy the express statutory requirements as well as the underlying assumptions and purposes for which the exchange is excepted from the general rule requiring the recognition of gain or loss upon the exchange of property.

(2) Section 371 (a) (1) applies only with respect to a reorganization effected in one of two specified types of court proceedings: (i) Receivership, foreclosure, or similar proceedings, or (ii) corporate reorganization proceedings under Chapter X of the Bankruptcy Act (11 U.S.C. ch. 10). The specific statutory requirements are the transfer of property of a corporation, in pursuance of an order of the court having jurisdiction of the corporation in such proceeding, to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation. If the consideration for the transfer consists of other property or money as well as stock and securities, see section 371 (a)(2) and (c). As to the assumption of liabilities in an exchange described in section 371 (a), see section 371 (d).

(3) The application of section 371 (a) (1) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent corporation; it is sufficient if the transfer is an integral step in the consummation of the reorganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.

(4) As used in section 371 (a) (1), the term "reorganization" is not controlled by the definition of "reorganization" contained in section 368. However, certain basic requirements, implicit in the statute, which are essential to a reorganization under section 368, are likewise essential to qualify a transaction as a reorganization under section 371 (a) (1). Among these requirements are a continuity of the business enterprise under the modified corporate form and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. Thus, the nonrecognition accorded by section 371 (a) (1) applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. For the purpose of determining whether the requisite continuity of interest exists, the interest of creditors who have, by appropriate legal steps, obtained effective command of the property of an insolvent corporation is considered as the equivalent of a proprietary interest. But the mere possibility of a proprietary interest is not its equivalent. In general, any transaction will be subject to nonrecognition of gain or loss as prescribed by section 371 (a) (1) where the property is transferred to a corporation and the stock and securities of such corporation are transferred to persons who were shareholders

or creditors of the transferor corporation as if such stock or securities had been transferred to such persons as shareholders pursuant to the nonrecognition provisions of part III, subchapter C, chapter 1 of the Code. The determinative and controlling factors are the corporation's insolvency and the effective command by the creditors over its property. The term "insolvent" as used herein refers to insolvency at any time during the course of the proceeding referred to in section 371 (a) (1), either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature.

(5) A short-term purchase money note is not a security within the meaning of this section, and the transfer of the properties of the insolvent corporation for cash and deferred payment obligations of the transferee evidenced by short-term notes is a sale and not an exchange.

(b) *Exchange for stock or securities and other property or money.* If an exchange would be within the provisions of section 371 (a) (1) if it were not for the fact that the consideration for the transfer of the property of the insolvent corporation consists not only of stock or securities but also of other property or money, then, as provided in section 371 (a) (2), if the other property or money received by the corporation is distributed by it pursuant to the plan of reorganization, no gain to the corporation will be recognized. Property is distributed within the meaning of this section if it is paid over or distributed to shareholders or creditors who have by appropriate legal steps obtained effective command of the property of the corporation. If the other property or money received by the corporation is not distributed by it pursuant to the plan of reorganization, the gain, if any, to the corporation from the exchange will be recognized in an amount not in excess of the sum of money and the fair market value of the other property so received which is not distributed. In either case no loss from the exchange will be recognized (see section 371 (c)).

(c) *Records to be kept and information to be filed.* (1) Each corporation a party to a section 371 (a) reorganization shall furnish a complete statement of all facts pertinent to the nonrecognition of gain or loss in connection with the exchange, including:

(i) A certified copy of the plan of reorganization approved by the court in the proceeding, together with a statement showing in full the purposes thereof and in detail all transactions incident, or pursuant, to the plan;

(ii) A complete statement of the cost or other basis of all property, including all stock or securities, transferred incident to the plan;

(iii) A statement of the amount of stock or securities and other property or money received in the exchange, including a statement of all distributions or other disposition made thereof. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the exchange;

(iv) A statement of the amount and nature of any liabilities assumed upon the exchange.

The information required by this section shall be filed as a part of the corporation's return for its taxable year within which the reorganization occurred.

(2) Permanent records in substantial form must be kept by every taxpayer who participates in a tax-free exchange in connection with a corporate reorganization showing the cost or other basis of the transferred property and the amount of stock or securities and other property or money received (including any liabilities assumed upon the exchange), in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received from the exchange.